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Hayek's Money Economy: The Dynamics of Competitive Equilibrium & Socio-Economic Order **G. R. Steele**

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HAYEK'S MONEY ECONOMY: THE DYNAMICS OF COMPETITIVE EQUILIBRIUM AND SOCIO-ECONOMIC ORDER

G.R. STEELE

Hayek's economics is focused upon adaptation: the continuously changing social order requires no conscious direction. That evolutionary thesis applies even to itself; no one can remain intellectually active throughout a long life without the adaptation of concepts or conclusions. If complete reversals are rare, reconsideration and refinement of notions previously held are normal. And while intellectual thought is consciously disciplined by the precepts of science and rationality, serendipity has the dominant role in the process of discovery.

Among the many aspects of the chronology of Hayek's work (see Hutchinson 1981, pp. 203–32; Caldwell 1988; Lawson 1994; Fleetwood 1995; Foss 1995; Witt 1997; Lewin 1997), one is afforded particular attention. Did Hayek continuously refine his notion of equilibrium, or was there an abrupt change? While this is likely to remain a moot issue, a case is presented for coherence and continuity in the important themes: the conceptualization of equilibrium within the money economy; the relevance of money's non-neutrality to business cycles; and coordination within the extended social order which is only possible within a money economy.

BUSINESS CYCLES AND EQUILIBRIUM THEORY

Interest in the origin and nature of business cycles had been kindled by the enormous price fluctuations across Europe in the 1920s. The search was for a feature of market economies that might serve as a general explanation. Here, the crucial problem was "the incorporation of cyclical phenomena into the system of equilibrium theory"[1] (Hayek 1933, p. 33 n):

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[1]This remains a live issue: the general observation that one business cycle is very much like any other business cycle, "suggests the possibility of a unified explanation . . . grounded in the general laws governing market economies" (Lucas 1977, p. 10) and "constructed so as to

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> production is governed by prices, independently of any knowledge of the whole process on the part of individual producers, so that it is only when the pricing process is itself disturbed that a misdirection of production can occur. The "wrong" prices, . . . which lead to "wrong" dispositions, cannot . . . be explained by a mistake. Within the framework of a system of explanations in which, as in all modern economic theory, prices are merely expressions of a necessary tendency towards a state of equilibrium, it is not permissible to reintroduce the . . . idea of the misleading effect of prices on production without first bringing it into line with the fundamental system of explanation. (Hayek 1933, pp. 84–85)

No doubt can exist: Hayek sets his task firmly within the framework of modern economic theory, which is structured upon a necessary tendency toward a state of equilibrium.

Hayek began his work on business cycle theory with an outline of some provisional ideas on "some extremely complex problems in pure theory" (Hayek 1928, p. 113). This had offered "an isolated analysis of what is so important a technical problem" (ibid., p. 114): "the significance of the temporal pattern of prices of a good for the undisturbed functioning of an economy" (ibid., p. 74) and the consequences of an "artificial stabilization of the 'price level' with the means available to monetary policy" (ibid., p. 113). Unless the (equilibrium) conditions are first established for an economy whose functioning is undisturbed by monetary forces, there is no basis for judging the likely impact of monetary policy.

Yet, the theoretical structure which Hayek built upon is not that which became popularized as mid-twentieth-century microeconomics. Hayek drew a distinction between "an economic system in which all processes are assumed to take place simultaneously, and hence all prices of all commodities of a given type are formed under the same conditions" (ibid., p. 71), (i.e., a static Walrasian general-equilibrium system), and

> the monetary economy, with prices which necessarily are set at successive points of time. . . . Instead of needing to explain merely the necessity for the existence of a particular structure of simultaneously existing prices and its function, what must now be done is to analyze the necessity and significance of relative levels of prices at successive points of time. (Ibid., p. 72)

The latter, which is the more difficult task, found no general appeal. Hayek describes his preliminary efforts toward those ends as the first attempt ever to analyze "the function fulfilled by the relative levels of prices at different points in time"[2] (ibid., p. 100). His conclusion—"that changes in the price level due to continuous improvements occurring in all branches of production are not merely

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predict how agents with stable tastes and technology will *choose* to respond to a new situation" (Lucas 1977, p. 12).

[2]"The paper is built on the notion, which we nowadays associate with Arrow and Debreu, that physically similar goods separated in time are appropriately treated as distinct entities whose prices are determined within a general-equilibrium system which extends over time" (Laidler 1994, p. 7).

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not detrimental but are even necessary if disturbances of equilibrium are to be avoided"—was in contradiction of the dominant view (but not in contradiction of the facts) that "only an invariable price level will ensure an undisturbed course of production" (Hayek 1928, p. 100).

The theoretical point is straightforward: to maintain stable prices, monetary expansion is required during a boom, and monetary contraction is required during a slump. So, if a monetary system were manipulated to prevent (necessary) price changes, there would be an additional monetary stimulus to production whenever real conditions were set for expansion, and an additional monetary curtailment of production whenever real conditions were set for contraction. Business cycles would be exacerbated.[3]

With his development of a dynamic version of the Walrasian system, in which monetary variations have the effect of causing a general over-expansion (or over-contraction) of production, Hayek was able to expose the detail of the incentives which derive from non-neutral money. Within a dynamic economy, neutral money

> refers to the set of conditions, under which it would be *conceivable* that events in a monetary economy could take place . . . as if they were influenced only by the "real" factors which are taken into account in equilibrium economics. (Hayek 1935, p. 130)

It was upon this basis that Hayek painstakingly attempted to build (Hayek 1931; 1933; 1935; 1939b; 1941) a monetary theory of business fluctuations and recommendations for the exercise of monetary policy.

The manner in which resources are integrated within more or less capitalistic (or roundabout) methods of production is central to Hayek's theory.[4] Any change to this structure of production has a cumulative impact. In setting Austrian capital theory within this dynamic framework, Hayek was able to explain how monetary expansion generates incentives which initiate a boom, but which steadily disrupt the balance between production methods. Whereas *Monetary Theory and the*

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[3]In the February 1929 report of the Austrian Institute for Business-Cycle Research, Hayek predicted an impending business crisis in the U.S. Against the widespread view that sustained growth would continue, Hayek warned that maladjustments were an inevitable consequence of monetary expansion and that a crisis was impending; the price stability which had accompanied sustained growth in U.S. real output was misleading. According to the prevailing orthodoxy, it signaled monetary stability. To Hayek it signified inflation: with rising real output, price stability was evidence of monetary expansion. On the favorable side, U.S. prices had not actually risen prior to 1927, so there was every reason to suppose that the (inevitable) recession would be mild. However, the U.S. authorities

> succeeded, by means of an easy-money policy, inaugurated as soon as the symptoms of an impeding reaction were noticed, in prolonging the boom for two years beyond what would otherwise have been its natural end. And when the crisis finally occurred, for almost two more years, deliberate attempts were made to prevent, by all conceivable means, the normal process of liquidation. (Hayek 1935, p. 162)

[4]A contemporaneous and related development was "Hicks's attempted dynamic recasting of general-equilibrium theory in *Value and Capital*" (Salerno 1994, p. 119, n. 3).

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Trade Cycle emphasized "the monetary causes which can *start* the cyclical fluctuations" (Hayek 1933, p. 17), *Prices and Production* focused more closely upon "successive changes in the real structure of production," which are the real phenomena of the trade cycle. Later still, and taking account of recognized defects in the earlier analysis, came *Profits, Interest, and Investment* and *The Pure Theory of Capital.* In the two earlier books, the impact upon investment incentives of a fall in the rate of interest (brought about by new money or new saving) is discussed. In the two later books, attention is directed at the impact upon investment incentives of changes in relative prices.

Although the conditions under which money remains neutral "will never be given in the real world," the most obvious pitfall is that of monetary expansion which directs capital investment into inherently non-viable areas as a consequence of its impact upon interest rates and relative prices. From this came the view that

> the only practical maxim . . . is probably the negative one that the simple fact of an increase of production and trade forms no justification for an expansion of credit, and that—save in an acute crisis—bankers need not be afraid to harm production by over-caution. (Hayek 1935, p. 125)

Of course, monetary contraction also misdirects capital investment and so the above proviso strengthened into the more emphatic argument that "there is no justification for supporting or permitting a process of deflation." In particular, positive intervention by the monetary authorities could bring advantages "in the later stages of a depression" when "deliberate attempts to maintain the money stream" would be justified to counter the "cumulative process of secondary deflation" (Hayek 1975, p. 5; see, also Hayek 1978b, p. 210).

Throughout, there is little or no concern with quantity theory conceptualizations: with "demand for money," "money supply,"[5] and monetary disequilibrium in the sense of an inequality of the two. Only upon one occasion were such topics briefly touched upon; in the 1928 essay, a supposed world-wide improvement in agricultural techniques and production stimulates (by the reduction of product prices) gold production:

> the temporary rise in the profitability of the sectors first affected by the gold inflow will have led to their expansion, an expansion which must show itself to have been unjustified as soon as the gold inflow slackens because of the rise in prices which takes place as a result of it. . . . The final effect of the gold movements will therefore be that the economy, in return for temporarily giving up a larger part of its overall output to the gold producers, will once again achieve an equilibrium between supply and demand only after it has incurred some losses. Apart from the losses caused by this disruption of equilibrium, every individual must see an additional source of loss in the fact that at least part of the rise in his money income does not represent for him a means to an increased acquisition of goods but constitutes his ultimate payment. Hence the only

[5]Note especially the items marked here in quotation marks (Hayek 1928, pp. 106 and 109).

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> recompense he obtains for that part of his output with which he has acquired it is that the stock of money he possesses has been uselessly enlarged. . . . when the money supply is expanded, the individual is forced to accept as final payment something which he had no desire to take as such. (Hayek 1928, pp. 110–11)

This concept of (temporary) monetary disequilibrium was developed no further: "it is not changes in the value of money which should be at issue, but disturbances of the inter-temporal price system which are without any economic function" (Hayek 1928, p. 99). Although, from the perspectives of neoclassical economics, the neo-quantity theory of money, and Keynes's General Theory, money had "a positive marginal utility due to its demand as an asset under conditions of uncertainty" (McCloughry 1984, p. x), Hayek drew nothing from arguments which elevated the status of money above the level of an instrument to facilitate the market process. Rather, on the basis of the theoretical structure first formulated in 1928, he criticized the conduct of monetary policy by "the fashionable pseudo-quantitative economics of averages with its argument running in terms of national 'price levels,' 'purchasing power parities,' 'terms of trade,' the 'Multiplier,' and what not" (Hayek 1939a, p. 45), and he cited Keynes as the "leading exponent" of a "pernicious" doctrine (ibid., pp. 2–3): "policies and practices which not long ago would have been frowned upon by all financial experts, are now generally employed throughout the world" (ibid., p. xi). Undoubtedly, Hayek sought to refute the clamor for monetary policy to be directed toward achieving "an autonomous rate of interest, unimpeded by international preoccupations": an option alleged to be open to all nations, and so a panacea to restore "economic health and strength internationally" (Keynes 1936, p. 349). In this, he failed.

EQUILIBRIUM

Nothing in Hayek's work suggests that the concepts of equilibrium and rationality were regarded other than as pivotal to economic analysis. Disequilibrium incites action. Rational action instigates coherent movement toward equilibrium. The exact theoretical characteristics of equilibrium and rationality are set by the principal paradigms of economics: from the Classical School (Walrasian general-equilibrium), the New Classical School (rational-expectations, neo-Walrasian general-equilibrium), and the Austrian School (communication and cohesion through the market process).

In Walrasian general-equilibrium, rational agents act upon full and certain information to equate marginal gains and losses. Under perfect competition, there is a Pareto optimal allocation of resources. Transactions dates and money are inessential.

Neo-Walrasian general-equilibrium incorporates uncertainty. Expectations are formed rationally in the sense that expectational errors are random. Action—motivated by an individually-held subset of information—affects prices which, thereby, embody the import of information not symmetrically available to all; i.e., there is an efficient market. Such exogenous (public) information is

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assimilated by spot and futures markets. Efficient market prices are an externality which allow all contractual arrangements to be optimally contingent upon future events. Transactions dates and money are inessential.

The Austrian paradigm also incorporates uncertainty but it allows for endogenous (private) information which cannot be used to define contingent circumstances (see Zappia 1996). In compromising the function of spot and futures markets and inter-temporal equilibrium, endogenous information is the starting point for sequence economics, path dependency, and multiple equilibria. Competition is an unending voyage of discovery wherein price movements are ambiguous: prices (1) embody the import of asymmetrically distributed exogenous information; but (2) are also an invitation to explore uncharted areas of ignorance. Equilibrium is defined as a set of *mutually compatible decentralized plans;* but endogenous information renders the requirements (i.e., the *ex post* elimination of *ex ante* incompatibilities) of Walrasian and neo-Walrasian general-equilibrium theory meaningless. Instead, rational action is defined in terms of institutional and contractual arrangements which incorporate incentive mechanisms to promote the most pragmatically efficient use of endogenous information.

The socialist calculation debate[6] of the 1930s had sharpened Hayek's criticisms of Walrasian general-equilibrium (for the neglect of informational aspects of competitive markets), but his own reformulations were open to (mis)interpretation to the extent that they can be represented as developments within *either* the New Classical *or* the Austrian paradigms,[7] *or* as a hybrid. Their details—which incorporate the allocation of economic resources *and* the fullest use of existing knowledge—are presented across four publications: "Economics and Knowledge" (Hayek [1937] 1949), "The Use of Knowledge in Society" (Hayek [1945] 1949), "The Meaning of Competition" (Hayek [1946] 1949), and "Competition as a Discovery Procedure" (Hayek [1968] 1978).

"Economics and Knowledge" is notable for Hayek's claim "that the coordination problem is *the* central problem"; for his "emphasis on subjectivity"; and for his "new definition of equilibrium" (Caldwell 1988, p. 514):

> in his early work Hayek virtually identifies economic theory with equilibrium theory; he thought that any legitimate economic theory must make use of some concept of

[6]The debate focused upon knowledge and calculation and the relative merits of centralized planning and the market economy. Even were it possible to centralize knowledge and to achieve the calculations for optimal resources allocation, the requirement to anticipate *future* prices would remain (see Salerno 1994). This is the crux; market competition is an adaptive process in which merit and luck are relevant to entrepreneurial success or failure: "[w]e allow the individual share to be determined partly by luck in order to make the total to be shared as large as possible" (Hayek 1978b, p. 91). Prosperity derives from profits earned by those who "discover new ways of doing things better than they have been done before" (Hayek [1946] 1949, p. 101).

[7]See Mark Blaug (1993):

> Let anyone compare Mises's 1920 essay on "Economic Calculation in the Socialist Commonwealth" and the treatment of the same issue in Mises's *Human Action* (1966), written after the publication of Hayek's papers, and the point is made. It is Hayek, not Mises, who deserves to be the patron saint of Austrian economics.

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> equilibrium. Hayek does not abandon this belief in "Economics and Knowledge," for he seeks to define equilibrium for both the individual and for society. What has changed is Hayek's new emphasis on subjectivism: any adequate definition of equilibrium must now take into account the fact that knowledge is subjectively-held and dispersed. (Caldwell 1988, p. 529)

Economists had overlooked the problem of knowledge. In conflating two different kinds of propositions—the *a priori* and the empirical—economists had obscured the relevance of any particular analysis "to the phenomena of the real world" (Hayek [1937] 1949, p. 56). The primary empirical task is to explain how "fragments of knowledge existing in different minds" (ibid., p. 54) are germane to the achievement of equilibrium "in the special sense in which equilibrium is regarded as a sort of optimum position" (ibid., p. 53).

The socialist calculation debate caused Hayek to emphasize subjectivism and the effectiveness of markets in reaching optimality of a sort. It is in respect of the latter that Hayek is placed in the vanguard of New Classical analysis. Prices reflect all the known alternative uses of resources:

> [i]n order that the results of the combination of individual bits of knowledge should be comparable to the results of direction by an omniscient dictator, further considerations must be introduced. . . . One condition would probably be that each of the alternative uses of any sort of resources is known to the owner of some such resources actually used for another purpose and that in this way all the different uses of these resources are connected, either directly or indirectly [footnote: That it is not necessary . . . that every possible alternative use . . . should be known to at least one among the owners is due to the fact that the alternatives known to the owners of the resources in a particular use are reflected in the prices of the resources]. (Ibid., pp. 53–54)

The "knowledge and intentions of different members of society are supposed to come more and more into agreement" (ibid., p. 45); but this could happen only if "the subjective data of different people . . . were due to the experience of the same objective facts" (ibid., p. 44). The problem is "how the 'data' of different individuals on which they base their plans are adjusted to the objective facts of their environment (which includes the action of other people)" (Hayek [1946] 1949, p. 93).

In attempting to explain this process of harmonization, the onus was upon economics to deal with "propositions . . . about causation in the real world" which rest upon "statements about how knowledge is acquired and communicated" (Hayek [1937] 1949, p. 33). Our social order relies upon a high degree of correspondence between objective facts and subjective data. Economics must explain the achievement of that correspondence with an empirically testable theory of expectation formation and learning: the "empirical element in economic theory . . . consists of propositions about foresight . . . [and] . . . the concept of equilibrium itself can be made definite and clear only in terms of assumptions concerning foresight" (ibid., pp. 33–34).

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This joint emphasis upon subjectivism and efficient markets is taken further in "The Use of Knowledge in Society," where "the problem of a rational economic order" is defined as "a problem of the utilization of knowledge which is not given to anyone in its totality" (Hayek [1945] 1949, p. 78). It is impractical to expect a central authority to deal adequately with "the economic problem of society [which] is mainly one of rapid adaptation to changes in the particular circumstances of time and place" (ibid., p. 83). It is not that the information is not there, but that the statistical procedure of "lumping together . . . items which differ as regards location, quality, and other particulars leaves the central planner in ignorance of these circumstances of time and place" (ibid.). Non-theoretical practical inarticulated knowledge is crucial, and it is the function of efficient markets to incorporate those multifarious exogenous particulars into decision processes.

Yet, rational expectations are only a part of the solution. Rational expectations are set in the context of exogenously (public) dispersed information, but many of the decisions which are most effectively left to the "man on the spot" also draw upon endogenous (private) knowledge, which derives from the unique position and activity of every agency. Endogenous knowledge is not conveyable by the procedures of fully informational rational expectations equilibrium. Access is gained only through the direct compliance of information-possessing agents: "the method by which such knowledge can be made as widely available as possible is precisely the problem to which we have to find an answer" (ibid., p. 81). An implicit complication is that no *ex post* appraisal is possible: only the actor knows what he knew. So it becomes necessary (the New Classical School must give ground to the Austrian School) to determine the nature of the institutional structures which are likely to facilitate the most effective use of endogenous information; i.e., "to provide inducements which will make individuals do the desirable things without anyone having to tell them what to do" (ibid., p. 88).

"The Meaning of Competition" gives further emphasis to the nature of social relationships as empirical processes of knowledge acquisition and dissemination: "the decisions of many individuals influence one another and necessarily succeed one another in time" (Hayek [1946] 1949, p. 93). This is the purposeless, continually readjusting, spontaneous market order (catallactics) which has nothing remotely equivalent to the optimal conditions for achieving some well-defined organizational goal (economics). Hayek laments that the competitive process—the moving force of economic life—is left almost undiscussed by economists: "[t]he argument in favor of competition does not rest on the conditions that would exist if it were perfect" (ibid., p. 104). Rather, under perfect competition there is no competition; in

> a highly organized market of a fully standardized commodity produced by many producers, there is little need or scope for competitive activities because the situation is such that the conditions which these activities might bring about are already satisfied to begin with. (ibid., p. 103)

There is no Paretian welfare loss: consumers can benefit from a monopoly supplier if the monopoly is achieved through superior efficiency, and providing it is constantly threatened by the discovery of even more efficient methods.

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In addition to the mutual adjustment of individual plans which the catallaxy achieves, Hayek asserts a further quality. It "produces in some sense a maximum or optimum" (Hayek[1968] 1978, p. 183) in that "as much will be produced as we know to bring about by any known method" (ibid., p. 185). Competition is not a zero-sum game, but one through which, by playing it according to the rules, the pool to be shared is enlarged, but

> [t]he so called "maximum" . . . cannot be defined as a sum of particular things, but only in terms of the chances it offers to unknown people to get as large a real equivalent as possible for their relative shares, which will be determined partly by accident. (ibid., p. 186)

The logic of economic choice defines *a priori* a set of optimum conditions; but the invisible hand mechanism of resources allocation is an empirical process. To qualify as a social (rather than mathematical) science, economics must analyze social processes: how does convergence (social equilibrium) occur in the context of changing preferences, technologies, endowments, and expectations? Explanations derive from an appraisal of social cohesion and economic performance under different institutional structures.

Although Hayek describes his early self as a "very pure and narrow economic theorist" dealing with "technical economics" (Hayek 1994, p. 91), those early preoccupations were with a social theory of sequential causation which bore no resemblance to the neoclassical paradigm of constrained optimization: "[i]n his first major paper he criticizes the notion of timeless, stationary equilibrium" (Caldwell 1988, p. 514). So, observations of the kind that "Hayek long ago abandoned any thoughts of end states" (Fleetwood 1995, p. 143) are inappropriate. The narrow economic theorist was fully alert to the significance of the assumptions with which he chose to work:

> the methodological valuable fiction is employed, at least initially, by which time is abstracted from. The analysis then begins from an economic system in which all individual processes are assumed to take place simultaneously. . . . The result is that the propositions arrived at in this stage of the analysis *provide no more than a partial explanation of what goes on in the economy as it actually exists.* (Hayek 1928, p. 71; emphasis added)

This work drew little from conceptual end states[8] which, *per se*, reflect nothing of the shifting evolutionary tendencies of continuous readaptation.

Although "endogenously emerging cyclical fluctuations in aggregate economic activity seem at odds with the notion of a spontaneous order," and although Hayek "never came back to discussing the business cycle from the point of view of his theory of the spontaneous order" (Witt 1997, p. 54), explanations are not

[8]A commentary on *The Pure Theory of Capital* (1941) is apposite: "but Hayek, of course, is not much concerned with stationary equilibrium. . . . He analyzes economic time paths in which, in general, relative quantities and relative values are always changing" (Steedman 1994, p. 11).

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hard to find. Even as the "pseudo-quantitative economics of averages" (Hayek 1939a, p. 45) engulfed the economics profession, Hayek found no cause to refute his early conclusions: that with any stabilization of bank deposits, "the stability of the economic system would be obtained at the price of curbing economic progress" (Hayek 1933, p. 191); and that conditions under which money would remain neutral "will never be given in the real world" (Hayek 1935, p. 125).[9] The advent of Keynesian monetary manipulations only reinforced the practical relevance of the monetary origins of business fluctuations, and brought the realization that no government could be trusted; that "only the market can discover the optimal quantity of money" (Hayek 1978a, p. 77; also see Hayek 1986).

The essence of a money economy is that decisions may be deferred, that informational requirements are minimized, and that an extensive social order of economic specialization, capital investment, and trading relationships is afforded maximum facilitation. These topics held Hayek's interest throughout. Only details changed. In the early period, attention was given to the linkages between monetary theory and equilibrium theory, where Hayek exposed the contradiction between the automatic equilibrating force of price adjustment and business cycle theories which were not grounded upon the disruption of equilibrium prices.[10] In the later period, the focus was upon the informational prerequisites which underlie equilibrium theory (see Butos 1985, p. 108).

Equilibrium is defined by the compatibility of subjective expectations, the coordination of plans based upon those expectations, and the consistency of those plans with an objective reality. According to Hayek, this is achieved by the dynamic feedback of competitive market processes. However, that achievement exists only as a tendency. Of course, the need to accommodate a variety of contingent circumstances implies that no plan is ever fully specified, so that "complete plan coordination *ex ante* is not even logically possible" (Lewin 1997, p. 14). Yet, as an intended criticism, this misses the point: rational actions (plans) are defined in terms of institutional and contractual arrangements which incorporate

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[9](Hayek 1935, p. 131):

> It is quite conceivable that a distortion of relative prices and a misdirection of production could only be avoided if, *firstly*, the total money stream remained constant, and *secondly*, all prices were completely flexible, and, *thirdly*, all long term contracts were based on a correct anticipation of future price movements. This would mean that, if the second and third conditions are not given, the ideal could not be realized by any kind of monetary policy.

In respect of the Monetarist rule of tracking real productivity growth, Hayek asserted that

> [i]t demands something similar yet significantly different, namely that the quantity of money (or rather the aggregate of all the most liquid assets) be kept such that people will not reduce or increase their outlay for the purpose of adapting their balances to their altered liquidity preferences. (1978a, p. 77)

[10]"[T]he only way out of this dilemma . . . [is] . . . the introduction of money . . . [which] . . . does away with the rigid interdependence and self-sufficiency of the 'closed' system of equilibrium and make possible movements which would be excluded by the latter" (Hayek, 1933, pp. 44–45).

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incentive mechanisms to promote the most pragmatically efficient use of endogenous information as a force to remove incompatibilities as and when they are revealed.

As a theoretical fiction, Hayek's concept of dynamic social equilibrium is no more or less fanciful than the static equilibrium of neoclassical theory, "since in order to arrive at a stationary equilibrium it would be necessary to pass through a phase in which the changes required to bring about a stationary state were still going on but their results were correctly foreseen" (Hayek 1941, p. 16 n). The theoretical structure of dynamic social equilibrium is simply a basis for the analysis of an existing state of affairs, which is necessary in order to reach "a prognosis of what is likely to happen in the future" (ibid., p. 22). Do current plans tally, or is disappointment inevitable? The purpose of that fiction is to provide a coherent basis for making that judgment; and it allows explanation in terms of causal sequences by revealing how and why an individual might feel compelled to alter any chosen course of action.

In seeking empirical verification of the tendency to social equilibrium, as the outcome of the spontaneous interaction of a multitude of individuals, the division of knowledge is a central issue. Knowledge of current prices and expectations of future prices are but a small part of the problem of knowledge. Wider issues relate to how, and under what conditions, different commodities might be obtained and used; but, within the succession of mistakes, reappraisals, and readjustments, the tendency to equilibrium is supported by the empirical evidence that prices exhibit a consistent tendency to correspond to costs.[11]

Competition as a process and equilibrium as an ever-receding goal were once commonly held conceptions,[12] but in the post-war period, the attention of economic theorists was increasingly grabbed by the neo-classical and Keynesian paradigms. Their grasp tightened to a stranglehold, and general familiarity with Austrian economics declined to the point where it became necessary to adopt new terminology in order to remove an ambiguity of meaning:

> [e]conomists usually ascribe the order which competition produces as an equilibrium—a somewhat unfortunate term, because such an equilibrium presupposes that the facts have already been discovered and competition therefore has ceased. The concept of an "order" which . . . I prefer to that of equilibrium, has the advantage that we can speak about an order being approached to varying degrees, and that order can be preserved throughout the process of change. While an economic equilibrium never really exists, there is some justification for asserting that the kind of order of which our theory describes an ideal type, is approached in a high degree. (Hayek [1968] 1978, p. 184)

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[11] "[B]y the time *The Wealth of Nations* appeared, competition had long been analyzed by a whole series of eighteenth-century authors as a process which brings temporary 'market' prices into line with underlying cost-covering 'natural' prices" (Blaug 1995, p. 3).

[12] "The replacement of the process conception of competition by an end-state conception . . . was finalized by 1933 or thereabouts" (Blaug 1995, pp. 3–4).

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So, the case that "[t]he notion, then, of order and a tendency towards order is fundamentally different from the notion of equilibrium and a tendency towards equilibrium" (Fleetwood 1995, p. 143), may be conceded, but only as a matter of semantics. This distinction may prove pedagogically useful, but it is one which can distort a retrospective view of the evolution of Hayek's economics. Such distortion lies in the suggestion that

> [i]n 1968 Hayek explicitly abandons the notion of equilibrium for the alternative notion of order. . . . Order, unlike equilibrium, is not an alternative description of an end state but rather a continual process of reproduction and transformation. . . . [S]pontaneous socio-economic order is not a different conception of equilibrium, it is the rejection of equilibrium and equilibrium economics. (Fleetwood 1995, p. 141; emphasis in the original)

There is no evidence in Hayek's published work that the notion of an end-state ever held any interest. Across more than 60 years of original publications (Hayek 1928; 1989), Hayek's notion of equilibrium was well-defined, dynamic, and consistent with his conceptualization of competition as a continuing process as opposed to a static end-state of affairs. The semantics are appropriate when they are used to clarify the development of a great idea, beginning with the focus of a narrow economic theorist, but widening to that of a philosopher with a vision of a multi-faceted social order. The technical economics was directed to business fluctuations and the relevance of money, and Austrian capital theory to those fluctuations. In shaping a wider perspective, Hayek emphasized the division of knowledge, its subjective nature, the problems of coordination, and the role of human action and market transactions in producing a coherent and evolving social structure.

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ARE MARKETS LIKE LANGUAGE?

LELAND B. YEAGER

Ludwig von Mises contributed much to understanding how markets work, of course, but he also showed a keen interest in language. I recall his mentioning, in two or three talks, the advantage for a scholar in economics and history, as he was, to be able to use research materials in more than just one or two languages. Economics and language as fields of study overlap in ways that give economists a legitimate interest in both. I'd like to develop this point before turning to the language-like aspects of markets, money, and prices.

Adam Smith ([1761, 1790] 1985) made conjectures about the origins of speech and writing and about how grammatically complex languages tended to grow more simple over time. Ludwig von Mises pursued his interest in language through many pages of his *Nation, State, and Economy* ([1919] 1983). He showed considerable knowledge of linguistics and language history. He explored how a standard language relates to its dialects. He explained, for example, how Vuk Stefanović Karadžić and Ljudevit Gaj, working separately, largely created the Serbo-Croatian standard language out of the existing dialects. He even made a prophetic remark (pp. 16–17) about how the language factor might lead the Slovaks to separate from the Czechs.

In particular, Mises explored relations between language and nationality. Why does a person identify himself (if he does) with a particular nationality? What is the essence of nationality? Not where a person lives, Mises said, not citizenship, not a shared history, and not race or ancestry. The nation is a speech community. "Community of language binds and difference of language separates persons and peoples" ([1919] 1983, p. 13). "A German is one who thinks and speaks German" (p. 13). Full mastery of a language, however, is not enough to define the speaker's nationality: he must speak it as his native language and must have "fully assimilated the special way of thinking that characterizes" it; he must process "everything he hears and sees in foreign languages through a way of thinking that has been shaped by the structure and concept formation of his own language" (p. 14). On such a definition, few persons belong to two or more nationalities, although some do. Occasionally, a person acquires an additional nationality or changes nationality.

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Mises did not want actually to impose a close match of political with linguistic boundaries, but he recognized advantages of a common native language within a political unit. No group then has a language advantage in political dialogue, and no group feels condemned to perpetual minority status because of language. (I'll return to this point later on.) Mises had observed such difficulties in the polyglot territories of Austria-Hungary and eastern Prussia, where speakers of different languages were mixed together even within localities. "In polyglot territories, democracy seems like oppression to the minority" ([1919] 1983, p. 56). Mises argued that the language factor went a long way in explaining why political democracy never really flourished in pre-World War I Austria-Hungary and Germany.

For reasons like these, and also for cultural reasons, Mises sympathized with movements for national liberation and unity, even irredentism. As he explained, liberal nationalism—in contrast with militaristic and imperialistic nationalism—can be an admirable attitude and a bulwark of peace. Different peoples should be able to respect and even share in each one's pride in its own culture and history.[1]

LANGUAGE AS SOCIAL SCIENCE

Both economics and linguistics can plausibly claim to be prototypical social sciences. Both investigate how people cooperate with one another and coordinate their activities. Both investigate instruments of communication (for, as I'll argue later on, markets, money, and prices do convey information, as well as incentives). F.A. Hayek observed that "In the field of social phenomena, only economics and linguistics seem to have succeeded in building up a coherent body of theory." Most of his remarks about economic theory, Hayek continued, "would appear to apply equally to linguistic theory" (1967, chap. 2, pp. 34–35). Hayek used language as a prime example of how people can come to follow rules that few could state explicitly. In words that make us think of Noam Chomsky's work, Hayek emphasized the striking "ability of small children to use language in accordance with the rules of grammar and idiom of which they are wholly unaware" (ibid., chap. 3, p. 43). Language illustrates the transmission of culture from generation to generation. A process of selection occurs through which "those modes of conduct prevail which lead to the formation of a more efficient order for the whole group, because such groups will prevail over others" (Hayek 1978, p. 9). Economic institutions and language alike, along with ethics and the common law, illustrate what Hayek, following Adam Ferguson, called "results of human action but not of human design" (1967, chap. 6); both illustrate spontaneously evolved phenomena that yet are open to deliberate modification.

[1] Difficulties with Mises's definition of nationality do come to mind. To his own satisfaction, he handled the cases of one language serving as the mother tongue in two or more countries, of dialects existing in parallel with a standard language, and of countries with two or more language communities. He explained why Switzerland, with four languages, is not an embarrassing counterexample. However, my purpose is not to pursue the question of nationality any further here.

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Linguistics has further claims to being a prototypical social science. Language is material for cultural anthropology. Language affinities provide clues to homelands, migrations, technologies, and other features and events before history became written. Linguistics seeks uniformities amidst diversities; it propounds hypotheses; it develops laws.

Sir William Jones, a British judge in India, published in 1786 his discoveries of systematic resemblances among Sanskrit, Latin, and Greek. He conjectured about the relations among these languages, about a common ancestor of them and other language families, and about processes of linguistic change.

Grimm's Law describes a whole series of sound changes as the Indo-European ancestor language evolved into Greek, Latin, and the Germanic languages and made those languages diverge from one another in systematic ways. Laws of the High German sound shift codify several systematic deviations between English and other Germanic languages on the one hand and modern standard German on the other. The individual Romance languages have diverged from their Latin ancestor in ways characteristic of each language. Their divergences exhibit systematic patterns and lawlike regularities.

These phenomena lead into the point that linguistics, like economics, employs methodological individualism. Both social sciences try to trace their laws to the circumstances and actions of individuals. Linguistics seeks to explain changes in language by their physiological and psychological convenience for the individual speaker in the environment confronting him. This environment includes the sounds used in his language and other circumstances that I'll mention.

The linguist André Martinet devotes sections of one of his books (1972, chap. 6) to the economics (or economy) of language and the costs of accomplishing its functions. These are communication primarily, but also sociability and play. To explain language traits and their changes over time, he invokes such ideas as George Zipf's "principle of least effort." Briefly, people try to accomplish the functions of language at lowest cost. The costs are efforts in positioning the vocal organs, in remembering sounds, words, meanings, and grammatical features, and in attending to messages received. A trade-off operates between precision and ease of use. Having very many units of sound and meaning helps make communication precise; on the other hand, fewness of such units, along with analogies among those that do exist, helps make the language easy to use.

The specific features making for ease of use depend on the environment confronting the speakers of a particular language. This environment consists of the whole body of its already existing features, including patterns suggesting psychologically appealing analogies of sound, meaning, and grammar. The environment also includes the objects and relations that people want to talk about, such as natural and social conditions and technology, as well as other languages that speakers of the particular language come in frequent contact with. Slurring over distinctions and using abbreviations becomes most tempting or economical for sounds and expressions in frequent use. *Chemin de fer métropolitain* became *métro* (so-called in

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Washington, D.C., as well as in Paris). All this is explainable broadly in terms of economy or cost-saving relative to effectiveness.

INDIVIDUAL AND SOCIETY

Language is a prime example of the sense in which the individual is a product of his society. The example is relevant to political economy—the area of overlap among economics, political science, and philosophy—and to questions of a suitable blend of individualism and communitarianism in the shaping of institutions and policies. In these interactions, language and ethics display parallels; and related questions concern, for example, life-styles and role models for youth growing up in poor communities.

All the words and meaning and structure of a language existing at a given time were contributed by individuals, mostly members of earlier generations. Each person grew up "into" an already functioning language. It shaped his thoughts, values, and activities. Words convey moral appraisals—for example, "murder," "shabby," "pig-headed," "tenacious," "principled." Without using socially given words and sentence structures, each of us could hardly think or reason at all. Yet, language results from the interplay of individual minds. Each individual and perhaps each generation has been influenced more by language than he or it has influenced language. Yet it, like moral traditions, is the creation of all individuals, past and present. (Here I have been paraphrasing Mises's friend Henry Hazlitt (1964, p. 167). It is noteworthy that Hazlitt applies methodological individualism to an unquestionably collective phenomenon.)

Recognizing the individual as a social product in no way denies that happiness and misery, success and frustration, are experienced by individuals; there is no such thing as collective happiness distinct from and transcending the happiness of individuals. Recognizing how society shapes its members in no way imposes collectivist or communitarian rather than individualist thinking and policies.

COMMUNICATION AND COORDINATION THROUGH LANGUAGE AND MARKETS

The role of prices in communicating knowledge enters into Mises's analysis of why accurate economic calculation is impossible under socialism. Without meaningful prices, planners could not calculate the cost of producing various quantities of any particular product. Cost means, ultimately, the value to consumers of alternative outputs sacrificed to produce the particular product. Planners in a nonmarket economy could not compare the costs and benefits to be expected from producing it in various quantities. Numerical data, especially market prices, are necessary for calculation; qualitative information is not enough (Salerno 1993, p. 121). Without genuine exchanges of factors and genuine market determination of their prices, central planners could not "cost" resources and allocate them efficiently or purposefully (ibid., p. 130). Quantitative results—suitable product and factor quantities—presuppose quantitative inputs. These must include, somewhere in the calculation process, the numerical

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specifics of utility and production functions. But these, along with the qualitative information that is also necessary, could never all be available for centralized, nonmarket decisions.

Hayek elaborated on Mises's analysis; at least that is how I interpret Hayek's contribution. He stressed

> the fragmentation of knowledge and its dispersion among the multitude of individual consumers and producers as the primary problem of economic and social cooperation and views the market's price system as the means by which such dispersed knowledge is ferreted out and communicated to the relevant decisionmakers in the production process. (Salerno 1993, p. 115)

Surely, in my view, no sharp contrast is warranted between attending to the fragmentation of knowledge and focusing "on monetary calculation using actual market prices as the necessary precondition for the rational allocation of resources within an economic system featuring specialization and the division of labor" (ibid., p. 125). Both paradigms, as Salerno calls them, enter into a full description of the problem and process of economic calculation.

Market prices, though essential to calculation, are not ultimate data. They represent intermediate steps in taking account of the more nearly ultimate data, often summarized as "wants, resources, and technology." "Costing" of output in a particular line of production requires somehow ultimately taking account of innumerable bits of information about production opportunities and processes in innumerable lines of production and information about consumer tastes for all sorts of products. In the words of Israel Kirzner (1996, p. 150), calculating the worth of a prospective action requires knowing "the importance to others of the goods and services one commits to that action, and the importance to others of the goods one will obtain from that action."

Already, it is clear that the calculation problem cannot be distinct from the knowledge problem.

The planners would need to know more than the technical aspects of production and more than the actual and potential tastes of consumers and workers. Efficient use of resources would further require using what Hayek (1945) called "knowledge of the particular circumstances of time and place." Examples are knowledge of a machine often standing idle, of whom to call on for emergency repair of a leaking boiler, of an employee's skills that could be put to more valuable use, of stocks of materials that might be drawn on during an interruption of supplies, of empty space in a freighter about to set sail, and of fleeting interlocal differences in commodity prices. Such localized and temporary knowledge can be used only by decision-makers on the spot, and would go to waste under centralization.

But decentralized decision-makers cannot work with this particular knowledge and technological knowledge alone. Efficient decisions must also take account of conditions in the whole rest of the economic system—the availabilities and value-productivities of resources in the innumerable lines of production

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competing for them. Here, Hayek's story portrays the price system as a vast computer and as a communicator of information and incentives, in abbreviated form, to all consumer and business decisionmakers to whom particular bits are relevant. Here, also—if the example were not already so familiar—would be the place to recite Hayek's example of the role of changed prices in motivating appropriate responses to an increased scarcity of tin, whatever caused it.

Markets convey information through prices in ways that resemble how language conveys information. But prices are not the whole story of how markets convey and mobilize information. Gluts and shortages of goods and services and undesired buildups and rundowns of business inventories become directly evident to market participants and motivate them to take action. In the imaginary world of abstract theory, the functions of the omniscient "Walrasian" auctioneer include not only establishing a general-equilibrium pattern of prices but also putting would-be trading partners into contact with one another and conveying information to each about the others' wants and capabilities. Not even in Walras's own writings, actually, does such a prodigious auctioneer exist. In reality, entrepreneurs ferret out lapses from what the auctioneer would have accomplished and try to remedy those lapses at a profit. Employment agencies, credit-rating companies, the general and specialized media, standard-setting and product-testing bureaus, wholesalers, department stores, franchisers, insurance companies, and all sorts of other firms perform information-mobilizing functions, besides taking part in establishing and responding to prices.

I can say more about how the market system puts knowledge to use by setting straight a common if vaguely expressed misunderstanding of Hayek's celebrated 1945 article, which I have already been drawing on. That misunderstanding has Hayek claiming that prices convey all the information necessary for well-calculated economic decisions. He does not claim that. He knows as well as anybody that prices are no substitute for knowledge of production techniques and of "the particular circumstances of time and place." I have already mentioned examples of such knowledge, and have explained why putting it to use requires decentralized decisions. Instead of being conveyed by prices, that local and fleeting knowledge is reflected in the actions of its possessors. Of course, those actions both affect and are affected by market conditions. And market conditions are often a sign of *dis*equilibrium prices.

But prices do convey much information, though not all, as is also true of language. They play a coordinating role. Current prices, which really are prices of the very recent past, are never completely correct in the sense of being solutions to a general-equilibrium system. Furthermore, they are mere clues, though indispensable clues, to what really counts: the prices that will prevail in the near and the more remote future. Entrepreneurs have incentives, however, to perceive and act on and thereby reduce price discrepancies, and to foresee the future correctly; and the profit-and-loss system works to weed out poor entrepreneurs and leave the administration of resources more in the hands of the perceptive ones. In this way, too, as Mises explained, the market makes knowledge available and puts it to effective use.

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LANGUAGE AND MONEY

I have been taking it for granted that prices are prices expressed in money. Their functions would be much impaired if prices were expressed in hodgepodges of barter exchange ratios. Mises's analysis of the role of prices in economic calculation under capitalism and socialism presupposed that prices were money prices.

Economists have long noted a close analogy between language and money. Joseph French Johnson did so in 1905:

> Just as language is a medium of exchange of ideas, so is money a medium of exchange of goods and services. Money performs its work by virtue of its exchangeability, and like language is in common use. Universal aphasia would have very much the same effect upon conversation that fluctuations in the value of money have upon the production and exchange of wealth. (Johnson, p. 172, quoted in Dorn 1987, p. 4)

James Tobin noted that the analogy is a

> time-honored observation of monetary economists. . . . Both are means of communication. The use of a particular language or a particular money by one individual increases its value to other actual or potential users. Increasing returns to scale, in this sense, limits the number of languages or moneys in a society and indeed explains the tendency for one basic language or money to monopolize the field. Theory must give way to history in explaining which language and what money . . . are adopted in any given community. (1980, pp. 86–87)

By a "particular money," Tobin evidently means (or should mean) a particular unit of account—dollar, franc, or whatever. Using different media of exchange, like banknotes and checking accounts of different banks, causes no great problem. The linguistic analogue of a unit of account is a particular language in the abstract—its vocabulary, grammar, and idioms. Particular documents and speech recordings correspond better to media of exchange.

Tobin noted (p. 87) that arbitrariness and circularity affect the acceptability of money, as the analogy with language suggests. Almost regardless of why a particular language or a particular money has become preeminent in particular territories or activities, that preeminence tends to reinforce itself. The main reason becomes obvious when one considers the position and choice of the individual user.

Kevin Dowd and David Greenaway (1993) examine how the individual's choice of a currency depends on the private benefits of using it, the network benefits (or external benefits, which hinge on the extent of its use by other people), and the costs of switching from one currency to another. They plausibly conjecture that marginal network benefits, though remaining positive, diminish with the size of the network. Though their article pertains to money only, its concepts apply rather obviously to language also.

Charles Kindleberger (1976), writing before the Bretton Woods system collapsed, drew the analogy between dominant languages and dominant currencies in international use. He mentioned English and the U.S. dollar. Costs of translation are a kind of transactions cost; they include loss of time or accuracy and loss of

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intimacy in communication. World efficiency requires all countries to learn the same second language, Kindleberger thought, just as the different nationalities of India use English as a *lingua franca*. The desire of the French to re-enthrone gold reminded him of wanting to resurrect Latin for international discourse. Flexible exchange rates would resemble a return to Babel, with foreign languages used by none save professional interpreters. The questions of optimum currency area and optimum language area are analogous. The optimum language and currency areas today are not countries nor continents, but the world. So said Kindleberger, calling for keeping the international dollar standard, which had evolved spontaneously anyway, just as the international role of English has evolved. I cite his essay and the one I'll mention next not to agree with everything in them but further to illustrate how economists employ the analogy between money and language.

Robert Barro invoked the analogy in a different spirit from Kindleberger; he pointed out what he considered some undesirable aspects of European monetary and political unification. I'll quote but mostly paraphrase from his 1992 article. Settling on a single language would eliminate translation costs. These savings would be far greater than the savings achieved by a common currency. Even so, small nations are often willing to bear high costs to promote their distinct languages, as in Catalonia and Quebec, which suggests that people there see real benefits in preserving a local common heritage linked to language. The benefits from maintaining national currencies might be much smaller than these cultural benefits and even yet outweigh the savings in transactions costs that a single currency would achieve. (Barro thus implies that the savings in transaction costs would be relatively slight.)

Monetary unification has costs of its own, Barro continued. It

> contributes to the centralization of government more broadly: It represents a repression of national identity that could also be applied to language, culture, per-capita incomes, the extent of public-sector activity, and so on. The appeal of a single currency is like the superficial attraction of central planning. . . . In both situations, the benefits from central planning are exaggerated and the rewards from competition are underestimated.

What is the ideal size of a country and, relatedly, the ideal domain of a language or a currency? Barro thought it best to avoid both extremes: "a single world government with one language and one currency and a proliferation of thousands of countries, each with its own media of speech and exchange."

MONEY AS A CLEARING DEVICE

Money, like written language, is a record-keeping device or, more exactly, a device for decentralizing and simplifying record-keeping. As such, it facilitates the clearing of multilateral exchanges. Clearing enables a person or firm to apply claims earned by delivering goods and services to some trading partners to pay for goods and services obtained from others. In a simple example (Schumpeter

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1970, p. 227), a surgeon operates on a singer, the singer performs at a lawyer's party, and the lawyer handles a case for the surgeon. If their services had equal value, the three persons might arrange to avoid actual payments to one another by canceling out their claims and obligations.

"Open stockpiles," as Robert Kuenne (1958) calls them, would be unworkable–letting each person contribute to and draw on the economy's total flow of production as he saw fit. Transactions must be identified somehow. Without clearing or some substitute, each person would have to pay for goods or services acquired from each trading partner by supplying that same partner with goods or services of equal value. Even though trading partners might avoid having to make their deliveries at the same time by granting each other short-term credit, this bilateralism of transactions would still be restrictive and inefficient.

The clearing of multilateral transactions requires somehow monitoring each person's contributions to and withdrawals from the flow of production to keep them in balance (with qualifications about trade in old goods, credit, gifts, and the like). If gathering and transmitting information (including information about the relative values of things), monitoring transactions, and keeping records were much easier and cheaper than they actually are (and if the Big Brother aspects were not ominous), centralized clearing could work.

In reality, decentralization by using money is cheaper and more efficient. Schumpeter calls money a "receipt voucher" for productive contributions and a "claim ticket" on goods to be received in exchange ([1917–18] 1956, pp. 154–55 and *passim*). Having money is presumptive evidence of being entitled to withdraw goods of equal value. To call money a clearing device–or, equivalently, a substitute for centralized clearing—is not to deny its function as medium of exchange; it is to examine that function more deeply. Money facilitates multilateral transactions because it is a relatively cheap and easy way of keeping track of who is entitled, on market principles, to acquire how much of various things. Money does what would otherwise be done more inefficiently by language, that is, by centralized and explicit written records.

We should not forget this prime function of money in the modern world by being too preoccupied with how money first evolved, correct though Carl Menger's story is. To suppose that the essence of a developed institution remains specified by its most primitive form, its genesis, is to commit the "genetic fallacy." "Money is not a commodity–not even when it happens to consist of a valuable material" (Schumpeter [1917–18] 1956, p. 161). It is a technical device for facilitating trade.

Yet some people overlook this central role as a clearing device and fall into thinking of money's ancient commodity aspect as somehow its essence. They exaggerate the supposed necessity of some ultimate or base money and worry about great structures of credit or claims pyramided onto a narrow base. They tend to think of deposit banking as a method of economizing on base money, and they worry about only fractionally backed deposits. These intuitions may apply to some monetary institutions, but not to money in general.

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Instability in the value of money tends to be subversive of calculation and coordination, much as instability in the meanings of words would be. For this reason, economists tend to favor institutions that preserve the value of money. Linking money to gold may be useful, as Schumpeter thought, to restrain the government from abusing the monetary system. Even so, sound analysis requires remembering how money resembles language more than it resembles gold.

Impairments to Coordination

Language difficulties provide examples of non-monetary impediments to coordination, perhaps in instructive contrast with monetary disturbances. Quebec law required, until its recent modification and with only minor exceptions, that outdoor advertising and other signs appear in French alone; and a provincial agency wields various incentives to promote the use of French even inside business firms. Such legislation must impair economic coordination to some extent, perhaps especially in cities bordering on English-speaking Ontario; and a clever researcher might devise ways of estimating how severe the effect is. I conjecture that any measurable effect would turn out to be slight in comparison with other impediments to coordination—in particular, with monetary disorders that render existing prices wrong. Non-monetary sources of disruption, such as language problems, are easy to diagnose. They come with built-in incentives for individuals to devise ways around them. The same is less true of monetary disruptions. But whether or not language barriers are found to cause serious disruption, the finding should be of interest to economists.

Incidentally, even substantial disruption would not unequivocally condemn Quebec language policy. The policy provides an interesting case study in political economy—in the issue of what should be done when individual rights and collective rights, as we might call them, are not fully compatible with one another.

An International Auxiliary Language and "Constructivism"

An auxiliary language is one created for use in international organizations and conferences and other international communications; it is not meant to replace national languages among their native speakers. Economic considerations, broadly considered, recommend adopting one. It could save most of the costs of working with and interpreting and translating among multiple languages. Being simpler, more regular, and easier to learn than any national language, dead or living, and being distinct from each of them, an auxiliary language would go far toward overcoming language barriers. Yet, it would be neutral, not favoring any particular nationality. (Remember Mises's related point about the disadvantage that linguistic minorities feel within individual countries.)

The concept of network effects, which I mentioned earlier, makes us wonder, though, how such a language could ever catch on. What reason would anyone have

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to learn it before a great many other people were already using it? Who would have any reason to go first?[2]

However, I'll stick to my theme of interrelations between language and social science. The question of an auxiliary language can be a focal example for discussions about the respective merits of spontaneously evolved versus deliberately contrived institutions, including economic and political institutions. Hayek has emphasized the unarticulated wisdom, the product of centuries of piecemeal sifting, that may be embodied in "the results of human action but not of human design" (1967, chap. 6). He has applied the epithet "constructivist" to schemes for overambitious social reconstruction. Some other members of the Austrian School have even distorted Hayek's insights into an actual criterion for appraising institutions and reforms. Ones that did evolve or could have evolved spontaneously as outcomes of social natural selection are supposedly meritorious for that very reason; others (notably some proposed monetary reforms) are "constructivist" and therefore bad. Some other economists have criticized Hayek because they think, wrongly in my view, that he did advocate spontaneous evolution as an actual test of desirability.

Charles Kindleberger has picked up this theme (although not, I suppose, directly from the Austrians). He says (ibid., p. 8) that "to seek to use newly-created international money or a newly-created international language would be patently inefficient." The analogy with Esperanto suggested to him the futility of a synthetic, deliberately created international medium of exchange. (Esperanto, by the way, is not the same thing as Interlingua, and is even something of an embarrassment to Interlinguists.) A linguistic expert might devise a better common language than Esperanto, he said, and something similar applies to Triffin's and others of the monetary reform plans in circulation when Kindleberger was writing. In his view (p. 10), however, all share the basic weakness of not growing out of the day-to-day life of markets.

But what is so decisively good about growing out of day-to-day life? Distinctions must be drawn; equating "spontaneously evolved" with "good" and "constructivist" with "bad" is simplistic. Institutions and practices that no one deliberately devised, even ones whose rationale no one has yet fully perceived and articulated, may indeed embody time-tested wisdom. Social scientists should treat them with a certain humility, instead of pushing to replace whatever they do not understand with some reformer's bright idea. On the other hand, no existing institution or practice is properly immune, merely on grounds of spontaneity and longevity, from investigation, appraisal, and modification or replacement. To tear down all of a society's institutions and rebuild from scratch according to a rational

[2]Here I am tempted to put in a plug for Interlingua, explaining why it is useful even to the individual learner, quite apart from any network benefits it might provide later on as more and more people came to use it. In particular, Interlingua is already useful for communicating with many millions and perhaps hundreds of millions of speakers of Spanish and other Romance languages, most of whom have never even heard of it. And it is a means to a deeper grasp of the international vocabulary of science and technology and to the vocabulary of one's own language. (Information is available at www.interlingua.com.)

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blueprint is indeed hubris. Quite different is assessing existing individual institutions and improving them piecemeal in ways found consistent with the healthy aspects of existing society.

Interlingua is far from an arbitrary invention. In standardizing existing languages and the already existing vocabulary of science and technology, the linguists who developed it paid scientific attention to the natural processes of linguistic evolution.

Many national languages are deliberate standardizations in that same general sense. The efforts of the Académie Française are well-known. Modern German arose as a kind of interlingua among medieval dialects. Serbo-Croatian resulted, as Mises observed, from two scholars' deliberate efforts to standardize the Illyrian and other South Slavic dialects (Mises [1919] 1983, p. 18). The resurrection and modernization of Hebrew as a spoken language traces to Eliezer Ben Yehuda, who immigrated to Palestine in 1881 and imposed the language, then spoken by him alone, on his wife and son (Masson 1983, esp. p. 454; several other articles accompanying Masson's in a three-volume set also cover the general theme of this paragraph). Turkish exhibits deliberate reforms undertaken under Kemal Atatürk. Modern Rumanian derives from efforts of nineteenth-century scholars and literary figures to standardize the dialects and enrich the result with borrowings, notably from French and Italian. Deliberate steps toward standardizing literary Italian on the basis of the Florentine dialect date back to the founding, probably in 1582, of the Accademia della Crusca, so called because its members sought to sift bad from good usage. For centuries, Italian was the language of only a small minority. Outside Tuscany and Rome, only literate people knew it; and in 1861, when the Kingdom of Italy was established, nearly four-fifths of the population were illiterate, and only around two-and-one-half percent could speak Italian. As late as 1951, the vast majority of Italians were still bilingual, most speaking a dialect as their first language. Publishing, motion pictures, and other cultural and political factors continue, however, giving the standard language momentum over the dialects (Migliorini and Griffith 1984, pp. 228, 352, 356, 363, 417, 510–12, and *passim*).

The upshot? I am not about to be intimidated by charges of "constructivism" either in language or in economic institutions.

In conclusion, I do not claim that markets, money, and prices are *just* like language but they do share some functions. All are instruments of what Mises called social cooperation. All help coordinate activities which are dispersed over space and time; all help mobilize knowledge and use it effectively, as in economic calculation. Language, markets, and money are prime examples of the largely spontaneous and only partly planned evolution of useful but often improvable institutions. Some analogies, particularly between money and language, are illuminating. They concern, for example, how dominance tends to reinforce itself through network effects, and how money facilitates multilateral clearing of exchanges through serving in effect as a monitoring and record-keeping device. More broadly, economics and linguistics have as much in common as probably the best-developed

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branches of social science. Economists may legitimately pursue an interest in language.

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THE ROLE OF FRACTIONAL-RESERVE BANKING AND FINANCIAL INTERMEDIATION IN THE MONEY SUPPLY PROCESS: KEYNES AND THE AUSTRIANS

JOHN P. COCHRAN AND STEVEN T. CALL

Timothy Fuerst (1994) has argued for the need for more banking theory in monetary theory.[1] A review of the history of economic thought indicates that, until the 1930s, banking theory and the role of banks in the process of financial intermediation and credit creation were emphasized in the writings of monetary economists beginning at least in the early 1800s.[2] In such theories, the role and impact of monetary policy on the economy follow as corollaries from a well-developed theory of money, credit, and banking.

This article presents two alternative interpretations of the role of banks in the monetary transmission process. The interpretation based on the work of Mises, Hayek, and Rothbard leads to the conclusion that central banking and monetary policy are the "generators of the 'business cycle'" (Hayek 1979). The other interpretation presents a Keynesian theory minus the liquidity preference theory of the rate of interest.[3]

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[1]Fuerst's paper examines how an economy responds to changes in the monetary base which enter the economy through a fractional-reserve banking system.

[2]See Rothbard (1995, chaps. 5–7) for a summary of this earlier literature. The works of Mises and Hayek are in this tradition.

[3]The framework provided here gives Keynesians an out from the "paradox of thrift" implications of the standard ISLM Keynesian model while retaining a strong argument for discretionary monetary and/or fiscal policies.

> [W]e regain the concept of savings as something more than an antisocial refusal to spend. It matters because it is also a supply of loanable funds. . . . We can make a clean break with one of the most dangerous and harmful confusions ever taught as accepted economic doctrine. (Leijonhufvud 1981a, pp. 196–97; see also Skousen 1997, and Samuelson 1997)

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These models provide an explanation of the indirect transmission mechanism that is an alternative to both the current money view and the credit and lending view.[4] The Austrian and Keynesian models developed here begin from a similar starting point: the loanable funds interest rate theory and the Wicksell transmission mechanism.[5] They differ in critical ways based on the following unresolved and often overlooked issues in the theory of money, credit, and banking:

1. Is money a present good or a future good?

2. Is a bank deposit (redeemable at par on demand) a debt transaction in both its legal and economic impact, or is the deposit a bailment in its economic impact even if it is treated as a debt by the legal system?

3. Is the money-creation process made possible by fractional-reserve banking true financial intermediation that facilitates the transfer of savings to investors, or is fractional-reserve banking and the money-creation process a credit-creation process?

Part 2 will discuss the interactions of money, credit, and interest, with special emphasis on the "Wicksell mechanism" and the natural rate of interest. Part 3 will develop an economic interpretation of fractional-reserve banking based on the work of Mises ([1912] 1971), Rothbard (1994), de Soto (1995), and Hoppe (1994). In this model, a bank deposit is considered a warehouse receipt, a bailment, not a debt.[6] The extension of circulating credit (credit issued from bank reserves acquired from deposit banking or created by a central bank) through the banking system eventually causes an economic crisis. The recession phase of the business cycle is the economic correction of previous excesses and malinvestment. Part 4 uses the basic Wicksellian framework to develop a model of money,

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[4]From our perspective, the credit and lending view is a step in the right direction. The focus is just too narrow. The emphasis should not be limited to bank lending, but should examine the impact of bank lending on total credit available relative to savings. See Romer and Romer (1990), Robinson (1993), and Morgan (1992) for more recent surveys of the money versus credit debate in the recent literature. Cochran and Call (1997) present a more detailed discussion of these issues in the context of the recent discussions on the monetary transmission process. Goldfeld (1990, p. 199), in his discussion of the Romer and Romer article, stated,

> I regard this topic with some nostalgia since it was one that many people of my generation encountered at a formative stage of their careers. Indeed, the question of whether bank loans are special and the role of banks in the transmission mechanism played a prominent part in my graduate education and early professional interests.

[5]See Cochran and Call (1997), Cochran and Glahe (forthcoming), and Garrison (1992) for more detailed discussions of the Wicksell connection.

[6]Even though such a deposit may be legally considered a debt, these economists view the economic incidence of bank deposits as a bailment. The distinction being made here is similar to the distinction between the legal and the economic incidence of a tax. See Rothbard (1994, pp. 41–45) and Mises ([1912] 1971, pp. 268–71). See de Soto (1995, pp. 29–30), for a discussion of the legal tradition dating to old Roman law where "custody, in irregular deposits, consists precisely of the obligation to always have an amount equal to that received at the depositor's disposal."

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banking, and credit that supports Keynes's (1936, p. 322) argument that abolishing booms will keep an economy in a permanent semi-slump. The model assumes that deposit banking is financial intermediation in both the legal and the economic sense. Part 5 compares and contrasts the two views, makes comments on the relevance of the old controversy for current monetary policy, and provides suggestions for future research.

MONEY, CREDIT, AND INTEREST

While most modern approaches to monetary theory and policy place a heavy emphasis on the analysis of the money demand function and the role of money as a store of value, the earlier literature in the Austrian tradition focuses on the role of banking institutions in the money-creation process, the importance of money as a medium of exchange,[7] and the role of monetary changes in the savings-investment process.

A major factor in the Austrian analysis is the recognition that the way money enters the economic system will affect the dynamic adjustment process. Institutions are an important component of the monetary-transmission mechanism.[8] As Yeager ([1990] 1997, p. 253) recognizes,

> Injection effects, in the broadest sense, can hardly be doubted: monetary expansion cannot leave all real quantities and relative prices the same as they would otherwise have been. New money enters the economy in particular ways and has differential impacts.

Or as stated much earlier by Cantillon ([1755] 1964), the demands of those who are initially affected by the monetary disturbance change before the demands of those who receive additional money balances only as the effects of the monetary change spread through the economy.

In contrast, the indirect transmission mechanisms of the more modern money view or lending-and-credit view are similar to the traditional direct transmission mechanism of the older Quantity Theory of Money. The means by which money enters the system is deemed irrelevant or of the second order of smalls. These are helicopter drop or "Angel Gabriel" models[9] of the monetary system. Monetary changes alter real cash balances. Economic agents respond through: (1) Pigou effects: aggregate demand is affected directly as agents alter spending on goods and services in response to changes in real cash balances; (2) Keynes effects (the money view): aggregate demand is changed indirectly as portfolio adjustments alter market interest rates; and (3) bank lending (lending and credit view): banks adjust the asset side of their balance sheet in light of the new monetary conditions. Changes in bank

[7]See Yeager (1968) for a detailed discussion of the importance of money as a medium of exchange.

[8]See Boettke (1997) for a discussion of the role of "ideal types" in the construction of economic theories and the importance of institutions and historical detail in "good" economic analysis.

[9]See Rothbard (1994, p. 22).

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lending affect aggregate demand as firms that are dependent on banks for credit increase or decrease their borrowing and spending.

Money, however, is seldom dropped by angels or from helicopters, or taken out of circulation by angelic pickpockets. Economic agents do not wake up with changed money balances. The money must enter (or leave) the system somehow and somewhere. In an economy with a developed banking system, monetary changes initially show up as changes in the availability of credit. Money enters the system (is created) as banks purchase assets (make loans).[10] The initial impact of a money supply change occurs in the market for credit as banks adjust both sides of their balance sheets.[11] Monetary changes that originate through the banking system have initial dynamic effects on spending because they alter not just bank credit but total credit available in the economy (or more correctly, credit available relative to savings available). A monetary change will thus alter the money rate of interest relative to the equilibrium rate and disrupt the balance between the "supply and demand" for capital. But it is important to note that it is not changes in the rate of interest *per se* that cause the demand-side changes, but changes in the rate relative to the rate that would equate saving and investment. As expressed by Wicksell ([1898] 1965, p. 107):

> It is only in this relative sense that the money rate of interest is of significance in regard to movements of prices. It can at once be seen that it is quite useless to try to demonstrate the existence of any direct relation between the absolute movements of the rate of interest or of the discount rate and movement of prices.

Changes in investment relative to saving alter the demand for goods and services relative to the supply and lead to price-level changes and/or output changes. The lending-and-credit view, with its sole emphasis on bank lending, takes too narrow a view of the monetary transmission process, while the money view begins too late in that process.[12] In the latter case, the effect on interest rates is considered only after the money supply increase is complete.[13] It is the effect of such monetary changes on the money rate of interest relative to the natural rate and the consequent effect on the decision to invest relative to the decision to save that constitute the saving-investment problem that is a key feature in this natural rate approach to the monetary-transmission mechanism.

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[10] Or leaves the system (that is destroyed) as banks fail to renew or call in loans.

[11] See Yeager and Greenfield ([1986] 1997) for a discussion of errors in monetary thought that result from the failure to clearly distinguish the demand for credit from the demand for money. The Post-Keynesian endogenous money models also consistently make this error. See, for example, Lavoie (1984) and Rogers (1989).

[12] Here is an area where Austrian insights on injection effects could perhaps be meaningfully combined with monetary disequilibrium models.

[13] The Wicksell mechanism does not preclude real balance effects, whether Pigou effects or Keynes effects. If the monetary disturbance occurs through a fractional-reserve banking system, then these spending effects occur, if at all, later in the transmission process. They do provide excellent alternative models of the economy-wide reaction to a helicopter drop. Direct effects would most likely dominate the response to such an experiment.

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COMMODITY CREDIT, CIRCULATION CREDIT, AND THE BOOM–BUST BUSINESS CYCLE

The ability of monetary changes to become a loose joint in the saving-and-investment process is what Leijonhufvud (1981a) has labeled the "Wicksell Connection"[14] and is developed from the idea, most clearly explained in Mises ([1912] 1971, p. 261), that banks play two distinct roles in the credit process: "the negotiation of credit through the loan of other people's money, and the granting of credit through the issue of fiduciary media, i.e., notes and bank balances that are not covered by money."[15] The first role, called "commodity credit" by Mises, is clearly financial intermediation. The second, Mises's "circulation credit," makes a distinction that was considered of vital importance at one time in monetary theory and is now usually ignored or discounted.[16] Credit issued by money creation is not considered financial intermediation.[17] It is not just another conduit of savings into investment.[18] The transaction is different in nature from a true credit transaction. In a true credit transaction, the lender temporally surrenders "money or goods, disposal over which is a source of satisfaction and renunciation of which is a source of dissatisfaction" (ibid., p. 264). It is different because the issuance of circulation credit involves no reduction of current satisfaction on the part of the ultimate lender, and hence may finance investment (or other spending financed by money creation) without any prior equal savings.[19]

Money is the medium of exchange, and is thus the present good *par excellence*. The implied household decision tree is: (a) Present goods or future goods (save)? (b) If present goods, specific consumption goods or money? Saving is the

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[14]See Cochran and Glahe (1994) for a discussion of the importance of the Wicksell connection in the Keynes–Hayek debate of the 1930s.

[15]See Rothbard (1994), de Soto (1995), and Hoppe (1994) for more recent developments of this formulation. These papers explore the economic and legal aspect of fractional-reserve banking from both a theoretical and historical perspective.

[16]Rothbard (1994) uses the term "loan banking" instead of Mises's term "commodity credit" to describe a bank's role as a financial intermediary, and uses the term "deposit banking" instead of the term "circulating credit" when discussing the role of banks in the money creation process.

[17]According to Mises ([1912] 1971, pp. 268–69), "It is usual to reckon the acceptance of a deposit which can be drawn upon at any time by means of notes or checks as a type of credit transaction and juristically this view is, of course, justified; but economically, the case is not one of a credit transaction." And, "But this is not a credit transaction, because the essential element, the exchange of present goods for future goods, is absent."

[18]The view Keynes accepted and the view implied in the lending and credit view and money view is that the distinction is either unimportant at best or false. Both forms of bank activity should be interpreted as true financial intermediation. See Part 4 of this article. See also Yeager ([1990] 1997, pp. 266–68) for a non-Keynesian approach that accepts the Keynesian interpretation of deposit banking as legitimate and necessary financial intermediation.

[19]De Soto (1995) makes the argument that deposit banking is essentially a fraudulent contract since the bank would be unable to meet all of its contractual obligations simultaneously. By legalizing such contracts, the government has granted bankers special privileges and has failed to fulfill its obligations to protect person and property from fraud and force.

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sacrifice of present goods (a claim on present goods is temporarily foregone) for a claim on future goods. Since the holding of cash balances, whether in the form of deposits or currency, does not require the sacrifice of present utility, changes in cash balances financed from current income are not a part of saving, but represent part of the allocation of income to provide present utility.[20] If money is a present good, then the proper economic interpretation of a deposit is that of a bailment or warehouse receipt. A deposit is a claim instrument, not a credit instrument.[21] If bank deposits are considered short-term loans from a legal standpoint, then the funds are legally considered the property of the bank and not the property of the depositor. But if such deposits (or notes) are used as a medium of exchange, they are in the minds of the depositor the property of the depositor. The deposits (notes) are a readily available source of current purchasing power. The depositor has not engaged in a true credit transaction, because no sacrifice of present utility has taken place. If banks hold fractional reserves (less than 100 percent) as backing of these deposits, and use the excess reserves to extend loans, the associated money creation is the economic equivalent of counterfeiting or embezzlement. The issuance of circulation credit is not financial intermediation. There has been no actual savings. Fractional-reserve banking and the use of circulating credit expands the supply of credit beyond the limits set by prior saving. Banking institutions will regularly push interest rates below the natural rate. Spending by ultimate investors will be in excess of savings.[22] Demand measured by monetary expenditure will increase and the resulting increase will initially be determined by the tastes and preferences of those borrowing the newly created purchasing power. Economic activity is misdirected in favor of early recipients of the newly created credit and at the expense of those whose expenditure flows increase later in the adjustment to the monetary shock.

This interpretation of the Wicksell mechanism is the foundation of the Austrian theory of the business cycle as developed by Mises and Hayek.[23] The extension of circulating credit (credit issued from bank reserves acquired from deposit banking) through the banking system eventually causes an economic crisis. The normal operations of the money and banking institutions supported by

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[20]See Rothbard (1976) and (Hutt 1979, chap. 8).

[21]See Rothbard (1978, pp. 148–49).

[22]This analysis assumes the newly created credit (bank loans) enters the system as loans to businesses. See Rothbard (1978, pp. 152–53), for a brief discussion of the effects on the economy if the credit enters the system as loans to government or consumers. While such loans may not generate business cycles, they do definitely generate a redistribution of wealth and purchasing power.

[23]See Rothbard (1970), Cochran and Glahe (1994), Hayek ([1931] 1935 and [1933] 1966), and Mises ([1912] 1971). Anderson ([1949] 1979) and Rothbard (1972) use the Austrian business cycle in their interpretations of the cause(s) of the Great Depression. See Yeager ([1990] 1997) for a critique of the use of Austrian business cycle theory in these explanations. Yeager's critique uses an interpretation of money, credit, and financial intermediation similar to the model of Keynes's reasoning developed in the next section of this article.

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a central bank generate business cycles by attempting to keep market rates of interest too low. The recession phase of the business cycle is the economic correction of previous monetary excesses and malinvestment.

BANKING, INTERMEDIATION, AND THE PERMANENT SEMI-SLUMP

Keynes (1936, p. 322), as a late voice in the Keynes–Hayek debate[24] of the 1930s, argued:

> Thus the remedy for the boom is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and keeping us permanently in a quasi-boom.
>
> The boom which is destined to end in a slump is caused, therefore, by a combination of a rate of interest, which in the correct state of expectation, would be too high for full employment, with a misguided state of expectation which, so long as it lasts, prevents this rate of interest from being in fact a deterrent. A boom is a situation in which over-optimism triumphs over a rate of interest which, in a cooler light, would be seen to be excessive.

According to Keynes, a production and exchange economy with a fractional-reserve banking system and well-developed financial markets following a *laissez-faire* policy would suffer from chronic unemployment. Money and banking institutions would operate so that the market rate of interest would, under a "correct state of expectations," be too high to ensure full employment.

In this section it is assumed that banks are financial intermediaries and issue liabilities that the public willingly uses as a medium of exchange. These liabilities are subject to reserve requirements (either voluntarily chosen or imposed as legal requirements). Banks also may acquire loanable funds by issuing other liabilities not used by the public as a medium of exchange and not subject to reserve requirements. For simplicity the model will assume that the public prefers bank-issued media of exchange to high-powered money. No distinction is made between commodity credit and circulation credit, or between loan banking and deposit banking. The relevant monetary theory and money demand analysis stresses the importance of money as a store of value. Money is treated as a future good, not a present good. Saving is defined as current income less household spending on consumption. The household decision tree is of the Tobin portfolio type: (a) consume or save; (b) if save, is it in the form of money or other financial assets. Hence, additions to cash balances financed from current income are

[24]While the explicit debate between Hayek and Keynes in the 1930s ended with Keynes's letter of, March 29, 1932, several passages in *The General Theory*, including the passage quoted above, are direct attacks on the Mises–Hayek or Austrian business cycle theory. The debate centered on differences of opinion concerning fundamental theoretical and institutional issues in monetary theory and capital theory. See Cochran and Glahe (1994; and forthcoming).

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viewed as a form of saving. Changes in the money supply (money demand) affect aggregate demand through real balance effects (wealth effects) and portfolio adjustments.

Financial intermediation should facilitate the flow of funds from ultimate savers (surplus units) to ultimate investors (deficit units). The sale (issuing) of bank liabilities that do not serve as a medium of exchange[25] is clearly of this type. The owner of the bank liability clearly has lent the funds to the bank for future considerations. Such intermediation is usually viewed as efficiency enhancing in a world with imperfect information. No change in the money supply takes place. Just as in a credit transaction without intermediation, the ultimate lender and the bank have a claim on future money and the borrower has acquired present money. The lender has a future claim on ready purchasing power, and the borrower has ready purchasing power.

The issuing by a bank of liabilities that serve as a medium of exchange may also be viewed as part of a financial intermediation process. The saver prefers liquidity to return, and decides to invest in money. The depositor lends funds to the bank and receives a bank I.O.U., a bank deposit payable on demand. The bank now has ownership of additional loanable funds. When these reserves are lent out, funds have been transferred from an ultimate lender (the depositor) to an ultimate investor. But in this case, new money has been created. Both the borrower and the ultimate lender believe they have readily available purchasing power in the form of money. As the borrowed money is spent, it returns to the banking system as additional deposits. The process continues as new deposits lead to more available loanable funds and new loans in turn create new money.

Banks may, however, for legal or economic reasons, deem it necessary to maintain cash reserves to back such short-term liabilities. The result: total lending will be less than total saving. A dollar held in a reserve balance is a dollar saved but not lent to an ultimate investor. The supply of credit will be less than available saving, and with "correct expectations," the market rate will be above the natural rate. The economy will be in a permanent semi-slump.[26] Investment will be less than savings, and Say's Law (in Keynes's sense) is broken. The income constrained process will then equilibrate output at a new lower level of output consistent with the new lower level of investment.[27]

Friedman (1982) asks important questions about monetary policy: "(W)hat should be the ultimate objectives of monetary policy?" What is the appropriate strategy? What tactics should be used to achieve the desired goals? Friedman asks the questions in the context of what he refers to as the "present monetary

[25]Rothbard (1976, pp. 180–81) would expand the Austrian definition of money to include all assets that are redeemable on demand at par in standard money. Such a definition would exclude "any form of genuine time liability."

[26]See Yeager ([1990] 1997) for an argument from a monetary disequilibrium perspective that comes to similar conclusions in a growth context.

[27]See Keynes (1936, esp. pp. 178–85).

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constitution," i.e., the existing "particular monetary standard and international monetary arrangements."

Friedman answers his own questions by suggesting that the possible objectives of monetary policy are the maintenance of full employment, suitable economic growth, and stable prices. He, argues, however, "Experience and not theory has demonstrated that the first two strategies are not feasible, that monetary policy is not an effective instrument for achieving directly either full employment or economic growth."[28]

No one argues that experience is unimportant. But in the absence of a well-grounded theory of money, credit, and banking, experience alone will be insufficient in addressing questions concerning the proper role and conduct of monetary policy. And while discussions of the best strategy for monetary policy, given the present monetary constitution, are important, so also are discussions about what the proper monetary constitution should be.

The theory of money, credit, and banking developed by Mises and Hayek implies that monetary policy would be ineffective in achieving full employment and adequate economic growth. Attempts to achieve such goals with monetary policy would, in the end, be destabilizing. (How much harm to the economy could have been avoided if past policy had been directed by good theory?) The Mises–Hayek model suggests that the more important question about monetary policy is not what are the strategies or objectives, but what is the appropriate monetary constitution. As Hayek (1979, p. 18) has suggested, in normal times, rules and institutions are more important than discretion in conducting monetary policy. The important concern is not how policy can help us achieve certain desirable goals, but how monetary institutions can be set up to eliminate or minimize the instabilities caused by inappropriate monetary policy.

The model developed in Part 4 of this paper, however, leads to just the opposite conclusions. Discretion on the part of the monetary authority is essential if the economy is to avoid a permanent semi-slump. Additional credit must be created to offset savings being absorbed into bank reserves and/or idle cash balances. Without a continuous injection of new reserves from a central banking authority, saving will exceed investment and output will be below its full employment level.

Not only must proponents of the Austrian monetary theory and Austrian business cycle theory convince critics that the capital structure of the economy is an extremely important and neglected aspect of economic theory, they must also convince these critics that the Austrian answers to basics questions in the theory of money, credit, and banking are plausible and powerful. Money as a medium of exchange is primarily a present good in an uncertain world. Deposit banking is dependent on a fraudulent contract. Deposit banking is, in an economic if not

[28]These strategies are : (1) "monetary policy should be directed specifically at promoting full employment"; and (2) monetary policy should be "directed at promoting growth through cheap money, through keeping interest rates low" (Friedman 1982, p. 100).

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currently in a legal sense, a bailment and not a loan. Fractional reserve banking backed by a central bank creates credit not backed by real savings and hence misdirects production into lines that favor the recipients of the new credit at the expense of current wealth holders.

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MANAGEMENT VS. THE MARKET: AN EXAGGERATED DISTINCTION

DON MATHEWS

Why do business firms exist? Do firms substitute for the market or complement the market? Why do firms buy some inputs but make others?

These are basic economic questions. Economists of different methodological stripes, as well as business historians, have attended to these questions, and their work has helped us better understand the functioning of the firm, but the leading answers to these questions fall short. It is the purpose of this article to show that Austrian economics provides some needed insight to the study of the firm.

COASE AND THE FIRM

The leading theory of the firm in economics largely remains the theory offered by Ronald Coase in his famous 1937 article, "The Nature of the Firm." Coase lays out the matter at hand.

> Outside the firm, price movements direct production, which is coordinated through a series of transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator, who directs production. It is clear that these are alternative methods of coordinating production. Yet, having regard to the fact that if production is regulated by price movements, production could be carried on without any organization at all, well we might ask, why is there any organization? (Coase 1988, pp. 35–36)

To Coase, what makes a firm a firm is vertical integration. When every level of a production process is carried out by independent contractors, Coase classifies it as production coordinated by the market. But when several levels of production are undertaken by a single entrepreneur, that arrangement is classified as a firm, an alternative to the market. In Coase's words: "A firm consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur" (ibid., pp. 41–42).

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Why do firms come into existence? Coase explained that in organizing production, a businessman must decide between using the market and managing. That is, he must decide whether to buy certain inputs on the market or to produce the inputs himself. There are costs either way. If he uses the market, he must determine what inputs are available and what the characteristics of those inputs are; he must negotiate contracts to use the inputs, and then he must make sure the terms of the contract are observed. If he produces the inputs himself, he must manage that production and incur all the costs that managing entails. The businessman will choose the alternative which he believes costs less. When it costs less to purchase inputs on the market, he uses the market. When it costs less to manage, he becomes an entrepreneur, and his operation becomes a firm; he supersedes the market, and produces inputs himself. In other words, firms come into existence when the cost of managing is less than the cost of using the market.

Coase uses his notions of managing costs and the costs of using the market to explain not only the existence of firms but also the size of firms. Firms grow so long as the costs of using the market exceed the costs of managing. The optimal size of a firm is attained when, at the margin, the costs of managing equal the costs of using the market.

CHANDLER AND THE FIRM

Another perspective on the firm to consider is that of business historian Alfred Chandler in his 1977 book *The Visible Hand: The Managerial Revolution in American Business.* Few works have influenced a discipline as much as Chandler's *Visible Hand* has influenced business history.

The Visible Hand is a rich history. Its theme is that "modern business enterprise took the place of market mechanisms in coordinating the activities of the economy and allocating its resources" (Chandler 1977, p. 1). Before the rise of the modern business enterprise, Chandler argues, American business firms were small, single-unit operations which generally produced a single product for a small geographic area. The activities of these firms "were coordinated by market and price mechanisms" (ibid., p. 3). But the modern business enterprise is a large, multi-unit operation which often produces many different products for many locations. Their activities, according to Chandler, are not coordinated by the market, but by managers. Specifically, "modern business enterprise took over the functions of coordinating flows of goods through existing processes of production and distribution, and of allocating funds and personnel for future production and distribution" (ibid., p. 1). In other words, the advanced enterprise superseded the market, and it did so because "administrative coordination permitted greater productivity, lower costs and higher profits than coordination by market mechanisms" (ibid., p. 6).

Chandler and Coase would find some things to disagree about, to be sure, but considering how enormously different the business historian's approach to the firm is from the economist's, the similarities in the two scholars' views are striking. Each

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sees vertical integration as the distinguishing feature of the firm. Each views management as a substitute for using the market. And each argues that firms supersede the market when managing costs less than using the market.

MANAGEMENT VS. THE MARKET?

Coase and Chandler can teach us much about the firm. However, the view that managing is fundamentally distinct from using the market is false.

What does using the market really mean? Coase is correct, of course, that there are costs to using the market. There are costs to any action. But when a firm searches the market to determine what inputs are available and how they might be employed, when it negotiates contracts to use the inputs, and when it measures and monitors the performance of the inputs, what is it doing? Isn't it managing?

We could say that what using the market really means is managed buying, and then press on with the Coase and Chandler argument by saying that the firm will produce its own inputs when the costs of managed buying exceed the costs of managed production, but to do so still leaves plenty of confusion. When a firm chooses to produce some of its own inputs and hires managers to coordinate that production, is it really superseding the market? Coase and Chandler say yes, but how does the firm come upon its managers? It buys their services in the market. Isn't that using the market?

The point is that the firm's decision to produce an input or buy it on the market —its make-or-buy decision—cannot be explained by creating a distinction between managing and using the market. No matter which decision the firm makes, the firm must manage and it must use input markets. Buying an input involves a whole series of decisions which amounts to managing; making an input requires the firm to use the market for managers. In other words, the firm's make-or-buy decision is not a decision about whether to manage or use input markets; it is a managerial decision about which input markets to use.

Above all, it is a profound error to assert that by employing managers to coordinate production a firm supersedes the market. Recall Chandler's thesis in *The Visible Hand*: "Modern business enterprise took the place of market mechanisms in coordinating the activities of the economy and allocating its resources." Not but ten pages later Chandler qualifies his theme. He states:

> The new bureaucratic enterprises did not, it must be emphasized, replace the market as the primary force in generating goods and services. The current decisions as to flows and the long-term ones as to allocating resources were based on estimates of current and long-term market demand. What the new enterprises did do was take over from the market the coordination and integration of the flow of goods and services from the production of raw materials through the several processes of production to the sale to the ultimate consumer. (Chandler 1977, p. 11)

But how can it be that the modern business enterprise supersedes the market "in coordinating the activities of the economy and allocating its resources" when the market is "the primary force in generating goods and services?"

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Chandler disciple William Lazonick makes the same error. Lazonick writes: "History shows that the driving force of successful capitalist development is not the perfection of the market mechanism, but the building of organizational capabilities" (Lazonick 1991, p. 8), and further, "Through managerial coordination, industrial corporations were able to develop the combined productive capabilities of human and physical resources in ways that market coordination, with its unplanned interaction of specialized producers, was unable to do" (ibid., p. 29). What must a business organization do to be successful? According to Lazonick, "it *must* develop its productive resources in order to produce a superior product at competitive cost, a saleable product at lower cost, or both" (ibid., p. 199). Yet, what is it that compels business organizations to attempt such things but market competition?

The notion that the firm supersedes the market is a variation of the socialist calculation error. Coase explicitly makes the socialist calculation error in "The Nature of the Firm." Of managing within the firm, Coase writes:

> Those who object to economic planning on the grounds that the [coordination] problem is solved by price movements can be answered by pointing out that there is planning within our economic system which is quite different from the [use of the price mechanism] and which is akin to what is normally called economic planning. (Coase 1988, p. 35)

But managing and planning the firm are not at all akin to "what is normally called economic planning." The market is not the impersonal buying and selling of goods and resources by independent contractors. The market is a system of private ownership rights which guides and constrains the actions people take to improve their situations. The market mechanism is the actions people take under a system of private ownership rights. The firm is a market institution. Firms are created and organized in certain ways by people seeking to improve their situations under a system of private ownership rights. Creating and organizing firms are part of the market mechanism. Hiring managers in an attempt to seize opportunities and create value is part of the market mechanism. Take away the market and the whole process in which people make economic decisions changes. Take away the market and there is no firm of the type we wish to better understand.

In other words, *managing* cannot be disassociated from *using* the market. There is a difference between making an input and buying it, of course, but the choice exists because of the market, and the choice is part of the market mechanism. The firm and all its actions cannot be disassociated from the market and the market mechanism.

THE FIRM AND THE MAKE-OR-BUY DECISION: AN AUSTRIAN PERSPECTIVE

It would be remiss to leave the matter of the firm and its make-or-buy decision hanging. So if we are to understand the firm and its make-or-buy decision, our focus should not be on the costs of making an input versus the costs of buying an

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input, but on the people who make the decision—entrepreneurs—and the environment in which they make the decision—the market. Comparing costs will likely lead us to a dead end for a number of reasons.

1. Costs are subjective. Costs are foregone alternatives, and the only relevant alternatives are those which an entrepreneur perceives. An entrepreneur asks: "How can we make our product? What alternatives do we have? Can we buy the inputs? Can we make the inputs?" The costs the entrepreneur confronts depend on how he answers those questions. And because the perceptions of entrepreneurs differ, the costs of buying an input versus the costs of making an input will differ from firm to firm.

2. Costs are uncertain. An entrepreneur does not know what it costs to produce a good until he produces it. He will anticipate expenditures and can compare anticipated expenditures to current and past expenditures and to the expenditures of other firms, but he cannot know his costs until he acts. And even then, he can never know what those costs *ought* to be. Neither can we.

3. Costs depend on the abilities of entrepreneurs. Entrepreneurs are not all alike; some are more daring, more ambitious, more perceptive, and more adept at economic calculation than are others. What that means is the productivity of an input depends not only on what the input is employed to do, but also on which entrepreneur employs it. This is another reason why the costs of buying an input versus the costs of making an input will differ from firm to firm.

It is certainly worthwhile for economists to think about the general kinds of costs firms incur when they make or buy inputs, but I do not believe that a general understanding of, say, agency costs or search costs will help us understand why a firm makes some inputs and buys others. As mentioned, the costs of making an input versus the costs of buying an input will differ from firm to firm.

What we can say about costs is that the firms with the lowest costs are the firms with the greatest entrepreneurial ability. As Kirzner and other Austrian scholars have pointed out, entrepreneurship can be found—and in the most successful firms *is* found—at many levels of a firm. Creating a firm is entrepreneurship, supplying capital to a firm is entrepreneurship, innovative managing is entrepreneurship. The most successful firms are organized in ways that persistently stimulate entrepreneurship at many levels. Such types of organization are quite complex and are extremely difficult for other firms to replicate. So it is likely that firms with great entrepreneurial ability will be able to produce a range of products—including some inputs—at less cost than other firms.

Firms with great entrepreneurial ability will perceive opportunities where other firms do not, and will be able to exploit those opportunities where other firms cannot. It may well be the case, as Coase and Chandler argue, that firms vertically integrate to reduce costs. But it might also be the case—and I believe it is more likely the case— that firms vertically integrate *because* they have lower costs as a result of their superior entrepreneurial ability. Even if Coase and Chandler are correct, entrepreneurship is the force behind vertical integration because entrepreneurship is what it takes to discover that vertical integration reduces costs.

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Thus, the size of firms and the number and types of products they produce will vary with the entrepreneurial ability of firms. That proposition is not novel, except here it is grounded in Austrian theory.

Austrian scholars have noted many times over that entrepreneurship is inherently speculative. The make-or-buy decision is a case in point. For entrepreneurs, the make-or-buy decision is anything but a well-defined problem; it's a gamble. At the time they make the decision, entrepreneurs do not know if their decision is correct or incorrect. Time and the market will inform them of that.

A story Chandler tells about the American Tobacco Company illustrates a number of the points addressed in this article. In the early 1900s, James Duke's American Tobacco Company attempted to dominate the cigar market in the same way that the firm had come to dominate the cigarette market. The attempt failed. Why? In Chandler's own words:

> Like wines the many different brands of cigars had distinctive tastes and flavors. Each appealed to a different type of customer. Cigars were not a product that could be mass produced and mass distributed, nor could the raw materials be produced in bulk. Since these processes did not lend themselves to high-volume throughput, administrative coordination did not reduce costs and so raise barriers to entry. Neither massive advertising nor effective organization could bring the dominance of a single firm to the cigar business. (Chandler 1977, p. 390)

There is no such thing as a firm superseding the market.

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REISMAN ON *CAPITALISM*

GEORGE REISMAN

The Review of Austrian Economics (*RAE*) recently published a review of my book *Capitalism: A Treatise on Economics* that, while praising my book to some extent, seriously misrepresents or altogether ignores major portions of it.[1]

Since a full analysis of the review would require twice as much space as the review itself, I will confine myself here to just a few instances of comparing the review's statements concerning my book with my book's actual content.

THE ALLEGED MISSING THEME OF SUPPORT FOR BUSINESSMEN

The first paragraph of the review reads as follows:

> George Reisman was a student of both Ludwig von Mises and Ayn Rand. Yet, Reisman's *Capitalism* discusses few typically Austrian or Objectivist themes. Amazingly, in a more than 1,000-page book, ostensibly influenced by both *Human Action* and *Atlas Shrugged,* there is no index entry for entrepreneurship. Nor will one find entries for the market process, subjective value, or evolution. Austrian business-cycle theory and welfare economics are unexpectedly under-represented. This list of lacunae is brought forward not as criticism, but to emphasize that, particularly in its most original aspects, *Capitalism* stands somewhat apart from any school or living tradition. Mises and Rand have influenced *Capitalism,* but surprisingly, Reisman's greatest influences are Adam Smith, David Ricardo, and John Stuart Mill.

It is difficult to interpret the third sentence of this paragraph other than to mean that my book ignores the strongly pro-business aspects of my ostensible intellectual heritage. What other "typically Austrian or Objectivist theme" can be meant if not the intellectual support of businessmen and capitalists that characterizes *Human Action* and *Atlas Shrugged?* Indeed, it really would be amazing, if that theme were absent from my book. But it is certainly not absent. True, the first printing of

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[1]Alexander Tabarrok, "Review of George Reisman's *Capitalism: A Treatise on Economics,*" *Review of Austrian Economics* 10, no. 2 (1997): 115–32.

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my book has no index entry for entrepreneurship. Despite my having worked several months on the preparation of the index, the index turned out to be less than perfect, and this entry was omitted. In future printings, this error will be remedied. An entry will appear that reads:"Entrepreneurs, See Businessmen and Capitalists." This will refer the reader to the more than nine column inches of index entries that appear under this latter heading.

What is truly amazing here is that the reviewer has claimed that the theme of intellectual support for businessmen and capitalists is not present in my book. To claim this, far more is involved than his failure to find an index entry for entrepreneurship. What is present is an apparent failure on his part to find a major portion of *the intellectual content* of my book. Frankly, I find it difficult to reconcile such lack of awareness with Mr. Tabarrok's actually having read these portions of my book. For if he had read them, it would have been impossible for him to claim that the theme of intellectual support for businessmen and capitalists was missing from my book.

Closely connected with this, I must immediately respond to the last two sentences of the review's first paragraph as well. Here the reviewer refers to the fact that "in its most original aspects, *Capitalism* stands somewhat apart from any school or living tradition." This much is true. But apart from citing my book's alleged omissions, the reviewer does not trouble to explain in what actual respects my book is distinctive, something he would seem obliged to do, especially since he explicitly refers to this fact. It is also true that the great classical economists he names have had a major influence on my thought, and precisely in the areas in which my book is most original. However, because the reviewer does not supply any specifics except these alleged omissions, what he implies is that the uniqueness of my book is defined by its unintelligible peculiarity, a peculiarity reinforced by its being subject to the influence of the classical economists, whom many contemporary economists, particularly the younger "Austrians," regard as the precursors of Karl Marx and thus as belonging to some kind of intellectual Dark Age and utterly unworthy of intellectual respect.

In order to make good the reviewer's deficiency here, allow me to refer to a major respect in which my book really does stand apart from any school or living tradition and does so precisely in its recognition of the productive role of businessmen and capitalists, and, moreover, precisely in a respect in which it is most heavily influenced by the ideas of the classical economists. This is the radical opposition between a major insight of my book and an erroneous basic assumption that is shared by, among others, Adam Smith, Karl Marx, and leading representatives of the Austrian School, notably, Eugen von Böhm-Bawerk and Murray Rothbard.

This latter idea, which is held by virtually all economists other than myself, I call *the primacy of wages doctrine.* It is the belief that wages are the original, primary form of income and that all other incomes, such as profit and interest, come into existence as a deduction from what is originally all wages. Profits appear, allegedly, only after the accumulation of capital and with the emergence of capitalists, as a deduction from what otherwise would be wages. According to

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Karl Marx, the deduction is unjust and constitutes the exploitation of labor. Adam Smith thinks virtually the same thing. Böhm-Bawerk and Rothbard think the deduction is justified, on the basis of time preference, and thus does not constitute any kind of exploitation of labor.

In my view, however, profits are *not* a deduction from what is originally all wages. On the contrary, profits are the original and primary form of income, and profit earners, not wage earners, are and continue to be the primary producers. The productive status of the wage earners is best characterized by the word "help." They are the profit earner's helpers in the production of what fundamentally are *his* products, not theirs. The actual consequence of the emergence of capitalists and the accumulation of capital, I hold, is the creation of productive expenditure, wages, and costs, and the consequent reduction in the proportion of income which is profit. The interested reader can find my discussion of these and related points on pages 473–85.

This radically distinctive, pro-capitalist view of the status of profits and of the relationship between capitalists and wage earners, based precisely on ideas of the classical economists, above all, on John Stuart Mill's proposition that "demand for commodities is not demand for labor," appears to have entirely escaped the reviewer. And because it has escaped him, he confronts the influence of the classical economists in my book with nothing but knee-jerk rejection.[2]

Misrepresentation of My Use of Classical Economics' Concept of Demand and Supply

The reviewer's out-of-hand rejection of classical economics makes him blind to the extremely valuable concepts of demand and supply employed by the classical economists, and which my book adopted and used to achieve extremely rewarding results. He writes:

> A related annoyance is Reisman's use of the so-called classical theory of price determination. According to Reisman, the classicals conceived of demand "as an amount of expenditure of money, such as $1 billion, while supply is to be understood as an amount of a good or service offered for sale" (p. 152). To illustrate, Reisman presents the following equation:

[2] I must say that considerations of space prevent my answering the other criticisms in the review's opening paragraph, except to note that while I do not have an index heading of "subjective value," I do have very extensive entries under the heading "marginal utility, law of diminishing," including more than one major entry referring to pages that the reviewer appears not to have read, especially the pages containing a very lengthy quotation from Böhm-Bawerk that both acknowledges determination of price by cost of production and demonstrates how such determination represents the operation of the law of diminishing marginal utility.(The quotation spans pages 414–16 of *Capitalism.*) I also wish to note that my theory of the trade cycle is fundamentally the same as that of Mises, in that I attribute it to government-fostered credit expansion, not to the operations of the capitalist economic system. My treatment does not significantly follow along the lines of Hayek's analysis, however.

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$P = D/S$

Where D is understood as an expenditure of money and S a quantity of goods.

Whether classical or not, this "theory" of price determination is untenable. How can consumers decide how much to spend on a good without first knowing the price? Are we to believe that consumers choose to spend, say, $1 billion on Coca-Cola without first knowing the price of Coca-Cola? If, for some unspecified reason, the supply of Coca-Cola falls, will consumers continue to spend just as much on Coca-Cola as previously? (*RAE*, p. 120)

It is almost embarrassing for me to have to point out the lack of familiarity with my book this last paragraph displays. In the very same section of my book from which the reviewer quotes and which serves to familiarize the reader with the differing concepts of demand and supply employed by the classical and contemporary economists, I carefully explain why the classical concept of demand applies *only at the level of the economic system as a whole,* where the volume of spending can be related to the quantity of money in the economic system and can be assumed constant so long as the supply of and demand for money for holding remain the same. In that section and in subsequent sections of the same chapter, as well as elsewhere in my book, I explain and illustrate repeatedly and exhaustively why, in contrast, the expenditure for any individual product cannot be assumed to be constant, but is subject to powerful competitive forces operating between the various products and industries, which continually shift the expenditures for individual products. To confirm these points, the interested reader should see, for example, pp. 155–58, 160, 179, 561–68, and 899–901 of my book. In these pages, by means of the assumption of a constant aggregate expenditure, I relate changes in expenditure for individual products and industries to equivalent, offsetting changes in expenditure in the rest of the economic system.

The reviewer concludes the paragraph I just quoted from with the rather bold assertion that "Reisman's so-called classical theory [of demand and supply] explains nothing" (p. 121). He then goes on to declare, in his very next paragraph, that:

Reisman accepts the classical doctrine of the wage fund which is simply the above equation [P= D/S] applied to the price of labor. (Take P as the price of labor, D as the demand for labor considered as a fixed monetary expenditure like $1 billion, and S as the fixed quantity of labor supplied.) This theory makes no more sense applied to wages than to any other price. Fortunately, Reisman doesn't take the theory too seriously and manages to argue to the correct conclusion that the average wage is determined by the average productivity of labor.

Here it is necessary for me to point out that I not only take the classical theory of demand and supply with total and absolute seriousness, but also consider it to be one of the most fruitful doctrines in the history of economic thought. A demonstration of its fruitfulness is provided precisely by the fact that I do not somehow, inexplicably, just "manage," as the reviewer puts it, to reach the

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conclusion that average real wages are determined by the average productivity of labor. The actual way I reach this conclusion is by dividing the classical economists' demand and supply formula for wages by their demand and supply formula for prices. When this is done, the result is that the average money wage rate divided by the general consumer price level, i.e., the average real wage rate, equals the aggregate demand for labor over the aggregate demand for consumers' goods, times the aggregate supply of consumers' goods over the aggregate supply of labor. This last expression reflects the productivity of labor. Other things being equal, a rising productivity of labor, I show, raises real wages in direct proportion by reducing prices in inverse proportion, while the average money wage rate remains the same. This is a rather significant result for a theory that allegedly "explains nothing" (see pp. 618–22).

The fruitfulness of the classical economists' formulas for prices and wages is further evidenced by the fact that these formulas make it possible to see the effects, if any, of a rising productivity of labor (and also of a changing supply of labor) on aggregate profits as well as on prices and real wages. This is because aggregate profits can be represented, at least as a first approximation, as the difference between the classical economists' concept of the aggregate demand for consumers' goods and their concept of the aggregate demand for labor. Profits equal sales minus costs. The demand for consumers' goods in the classical sense is consumer sales revenues. The demand for labor in the classical sense can be taken as total wage costs. Since the demand for capital goods has been omitted from both sales and costs (later in my analysis it is brought in), the difference between the demand for consumers' goods and the demand for labor can be taken, as I say, as a first approximation to aggregate profits. Among the results of this framework of analysis is the realization that falling prices caused by increased production do not reduce the aggregate amount or average rate of profit in the economic system and thus that they do not constitute deflation. Deflation, it follows, is to be understood strictly as a phenomenon of monetary contraction. This framework of analysis, incidentally, is what underlies virtually every aspect of my exposition of Say's Law and makes the reviewer's positive appraisal of that portion of my book somewhat difficult to explain. (For my treatment of these points, see pp. 569–74.)

MISSTATEMENT OF MY DEFINITION OF ECONOMICS

I must mention the serious matter of the reviewer's misstatement of my definition of economics and his ignoring of my explicitly stated views on the applications of the subject. On the very first page of Chapter 1 of my book, I write: "I define economics as *the science that studies the production of wealth under a system of division of labor*" (p. 15. Italics in original). I then go on, at considerable length, to explain why the division of labor is "the essential fact that necessitates the existence of the subject of economics." I also point out that:

> Apart from the very survival of a division-of-labor society, and all that depends on it, the most important application of economics is to provide the knowledge necessary

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> for the adoption of government policies conducive to the smooth and efficient functioning of such a society. [In the note that occurs at this point, I write: "Because of its primary application to government policy, it is understandable why the subject was originally known as political economy, which was its name from the time of Adam Smith to the last quarter of the nineteenth century, when the change to "economics" took place."] On the basis of the knowledge it provides, economics offers logically demonstrable solutions for politico-economic problems. For example, it explains very clearly how to stop such major present-day problems as inflation, shortages, depressions, and mass unemployment, and how to turn capital decumulation into capital accumulation and a declining productivity of labor into a rising productivity of labor. In addition, economics can very clearly show how to achieve economic progress all across the world, and is potentially capable of playing an enormous role in eliminating the intellectual and economic causes both of domestic strife and of international conflict and war. As I will show, the essential nature of the policies economics demonstrates to be necessary to solve all such problems is respect for property rights and economic freedom. (pp. 17–18)

The reviewer's translation of my definition appears in the following passage:

> Reisman's analysis of socialism belongs to the field of what most economists would call political economy or public choice. Thus, it is rather odd that Reisman insists that economics is *the science of wealth,* and that Mises is confused when he calls economics a branch of a larger field which studies human action (see, p. 42 and chap. 2, n. 12). The post-1950 rise and contributions of public choice, social choice, law and economics, and Chicago-school sociology make it eminently clear that Mises's understanding of economic method is correct. (*RAE,* p. 118, n. 1. Italics supplied.)

Is it really possible that the reviewer could have read my definition of economics, my reasons for that definition, and my integration of that definition with the leading applications of economics, and then still have written the above passage?

Misrepresentation of My Views on Time Preference

The reviewer equally misrepresents my explicitly stated views on time preference as a determinant of the rate of profit and interest, when he flatly declares: "Reisman rejects the time-preference theory of interest primarily because it explains a rate of return in terms of goods" (p.125, n. 11).

The truth is that I do *not* reject the essential role of time preference in determining the rate of profit and interest. Indeed, in my treatment of profit I explain at the outset that I

> trace the phenomenon of net consumption [i.e., the excess of the demand for consumers' goods from business over the demand for labor by business] back to time preference and show that net consumption is actually the vehicle by means of which time preference determines the rate of profit. (p. 723)

Later in the same chapter (chap. 16), there is a subsection with the title "Net Consumption and Time Preference " (pp. 743–44), which elaborates my views on

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the relationship between time preference and the rate of profit and interest. It opens with the statement that:

> Net consumption is not an ultimate cause of profit. It itself reflects the operation of time preference. . . . Time preference determines the proportions in which people devote their income and wealth to present consumption versus provision for the future. The higher the prevailing degree of time preference, the higher is the proportion in which people devote their wealth and income to present consumption in comparison with provision for the future. The lower the prevailing degree of time preference, the lower is the proportion in which they devote their wealth and income to present consumption in comparison with provision for the future. In this way, time preference operates to establish the rate of net consumption. (p. 743)

It should be clear from the very title of my section "Exposition and Critique of the Time-Preference Theory in Its Traditional Form" that what I criticize is not the time-preference theory as such, but only the traditional version of it. To be specific, I criticize the claim that time preference *directly* determines the rate of profit and interest. I hold instead that its influence is indirect, via determining what I call the rate of net consumption. Furthermore, contrary to the reviewer, I do not reject the traditional version "primarily because it explains a rate of return in terms of goods." I reject it for a variety of reasons, among which is the fact that it fails to do what any valid theory of the rate of profit and interest absolutely must do, which is to explain the rate of profit and interest in terms of money, as well as in "real" terms. The scope of my criticisms is indicated by the titles of the various subsections in my critique, namely: "The Contradiction Between Böhm-Bawerk's 'First Cause' and the Doctrine of the Purchasing-Power Premiums," "The Discounting Approach," "The Disappearance of the Higher Value of Present Goods at the Margin: Böhm-Bawerk's Abandonment of the Time-Preference Theory." (The critique spans pages 792–97 of my book.)

AGGREGATE ECONOMIC ACCOUNTING AND "MACROECONOMICS"

My greatest disappointment with the review concerns its treatment of my views on aggregate economic accounting and "macroeconomics." The reviewer declares: "Reisman's discussion mostly recounts earlier work in the Austrian tradition without building much upon that work" (p. 128).

Here I must say that anyone who cares to take the trouble to read my book will easily be able to see that my treatment of aggregate economic accounting and "macroeconomics" goes far beyond that of earlier authors. For example, I go on to elaborate a new system of national-income accounting in which the very equality of national income and net national product, which is at the core of contemporary national-income accounting, serves to confirm that most spending in the economic system consists of *productive expenditure*, not consumption expenditure.

Productive expenditure, the concept of which has been absent from economics since the demise of classical economics, means expenditure for the purpose of

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making subsequent sales. It is financed by the gross saving of businessmen and capitalists. I demonstrate that the net investment component of net national product is productive expenditure for capital goods and labor minus the very same costs that business firms deduct from sales revenues in arriving at their profits and thus that most spending in the economic system is concealed under net investment. (The virtually dollar-for-dollar positive relationship that is found to exist between changes in net investment and changes in aggregate profits serves later in my book in the overthrow of the Keynesian *IS* curve and the doctrine of unemployment equilibrium.) (On these points, see, pp. 699–707, 744–50, and 882–83.)

Even more importantly, my book explains how awareness of the separate, distinct demand for and production of capital goods leads to a radically new and different theory of capital accumulation and of the relationship of capital accumulation to the rate of profit and interest. In this theory, capital accumulation is seen to be the result not only of saving but also of practically *anything whatever* that serves to increase the ability to produce. An increase in the ability to produce includes an increase in the ability to produce capital goods and thus, given the productive consumption of capital goods, results in additional capital accumulation.

One major result of this perspective is the realization that technological progress, rather than playing the role of adding to the demand for capital while saving alone increases the supply of capital, is itself a leading *source* of capital accumulation. Another is the realization that increases in the supply of *labor* result in increases in the supply of capital goods, as does international free trade and, above all, economic freedom in general. On this foundation, I explain, for example, the inability of the former Soviet Union to accumulate significant capital. The explanation is the utter inefficiency of socialism, which resulted in the inability ever to produce many more capital goods than were used up in production except at the price of producing so few consumers' goods that mass starvation resulted. On the same foundation, I also develop an argument that free immigration into a laissez-faire capitalist society actually contributes positively to capital accumulation per capita, by virtue of increasing the ability to produce capital goods relative to the productive consumption of capital goods (see, pp. 622–42, 709–12, and 362–66).

My book shows that the role of saving in capital accumulation is fundamentally one of *force to acceleration*, rather than being one of force to motion. This becomes clear in the context of an economic system with a fixed quantity of money and a fixed aggregate demand for products, in which a rise in saving and fall in consumption serves to increase the demand for capital goods relative to the demand for consumers' goods and thus to bring about a more rapid rate of capital accumulation. A leading implication of this perspective is the realization that capital accumulation can occur with a stable relationship between the demand for capital goods and the demand for consumers' goods and thus without any fall in the rate of profit or interest (see pp. 813–20).

Another leading implication is that what necessitates a continuous rise in the demand for capital goods as a condition of capital accumulation is the increase

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in the quantity of money and volume of spending, which constantly raises the demand for consumers' goods and thus requires a continuing rise in the demand for capital goods if the same ratio of demand for capital goods to the demand for consumers' goods is to be maintained. A corollary of this is the realization that the continuous net saving out of money income that goes on in the real world, far from being the source of a declining rate of profit and interest, is actually accompanied by a *positive addition* to the rate of profit and interest. This addition, I show, is constituted by the rate of increase in the quantity of money and volume of spending, which systematically raises sales revenues relative to costs, which are always largely historical. The rise in the quantity of money and volume of spending, if modest (as it almost certainly would be under a gold standard) and outweighed by the rate of increase in the production and supply of goods, can, of course, be accompanied by generally falling prices. And these falling prices, far from reducing the rate of profit and interest, are accompanied by this same positive addition to the rate of profit. This, of course, powerfully reinforces the conclusion named earlier that falling prices caused by increases in production are in no sense deflationary—that deflation is a phenomenon of monetary contraction, not of falling prices due to increased production (see pp. 762–75, 834–37).

The preceding several examples, along with the overthrow of the primacy-of-wages doctrine that I mentioned earlier, are important examples, but by no means the totality, of what I believe are my book's original and important contributions in the areas of aggregate economic accounting and "macroeconomics," but which simply went unnoticed in the review.

In this response, I have dealt with five instances of misrepresentation in the review: its claim that I ignore the essential theme of support for businessmen and capitalists, its misrepresentation of my use of classical economics' concept of demand and supply, its distortion of my definition of economics, its misrepresentation of my views on time preference as a determinant of the rate of profit and interest, and finally, its denial of my contributions to aggregate economic accounting and "macroeconomics." These five instances are merely a good sample. The review has other serious instances of misrepresentation as well, such as those concerning my treatment of the subjects of cost of production and marginal productivity, my criticism of the circularity in contemporary economics' concept of demand, and above all, my treatment of the positive theory of profit. Regrettably, lack of space prevents me from proving such further misrepresentations here. But I am confident that they will be obvious to any serious reader of both the review and my book.

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RESPONSE TO REISMAN ON *CAPITALISM*

ALEXANDER TABARROK

Reisman's *Capitalism* is longer than either Mises's *Human Action* or Rothbard's *Man, Economy, and State*. It thus seems unreasonable to object to my review because it ignores major portions of his work. Reisman's other objections are similarly weak.

Capitalism has surprisingly little to say on entrepreneurship or other typically Austrian and Objectivist themes. I do not think any objective reader would infer from my statement that Reisman is a socialist. Nevertheless, this is Reisman's reading. For the record, Reisman is a strong proponent of capitalism. In *Human Action*, Mises (1966, p. 253) calls entrepreneurs the "pioneers of economic improvement." In Ayn Rand's works, the great capitalists are heroes and visionaries, every bit as creative as the great artists and scientists. In Reisman's book, capitalists are mostly owners of capital. One will not find stirring descriptions, for example, of Carnegie, Rockefeller, Groves or other titans of industry in *Capitalism*. As I stated in my review, I do not object to Reisman's not placing entrepreneurship at the heart of the economic process. I am merely surprised.

Reisman believes that I did not explain in what respects his book is distinctive. He has no difficulty understanding, however, that I imply that the uniqueness of *Capitalism* "is defined by its unintelligible peculiarity, a peculiarity reinforced by its being subject to the influence of the classical economists." Yes, that is it.

One distinct idea in Reisman's book is his rejection of the "primacy of wages doctrine." Here we have an all-too-typical move by Reisman. A doctrine is introduced and stated to be of great importance in classical and contemporary economics. Reisman then demolishes the doctrine and establishes his own unique views. All this would be most impressive if the doctrines Reisman demolishes actually existed. True, a plausible case can be made for many of the Classicals believing something like the primacy of wages doctrine, but to suggest that Rothbard (along with "virtually all economists" other than Reisman) believes wages are primary and all other incomes are deductions from wages is absurd.

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Reisman's discussion of the primacy of wages doctrine did not escape me; I ignored it to concentrate on better aspects of his book. Alas, he is not grateful for my oversight. For what it is worth, the contemporary view (going back to John Bates Clark [1899]), is that profits (in the sense of capital income) are not deducted from labor income, nor is labor income deducted from profits. Instead, both capital and labor income are determined jointly according to their marginal product.

I indeed failed to understand that Reisman wants the classical notion of demand and supply to apply only to the economy as a whole. But the misunderstanding could have been avoided had Reisman chosen to express himself in standard terms. If in the equation P=D/S, P is the price level, D is aggregate spending on consumer goods and S the aggregate supply of consumer goods, then Reisman's theory is nothing more than the quantity theory of money, P=M•V/Y, because M•V is spending on consumer goods and Y is the supply of consumer goods.[1]

In the last 40 years, the methods and tools of economics have increasingly come to be applied to fields like political science, law, sociology, and ethical philosophy. Mises's insistence that economics is but one part of a larger field which studies purposeful human action thus looks prescient. Reisman, in contrast, favors a much older definition of economics, "the science that studies the production of wealth under a system of division of labor." In a footnote to my review, I pointed out that Reisman's definition suffers by contrast with Mises's because it cannot make sense of the post-1950s expansion of economics into cognate fields. It is unclear why Reisman finds my statement of his views to be in error. On page 42 of *Capitalism,* he discusses "the mistaken claim that economics is a science of choices rather than a science of wealth," and later on the same page, "To claim that economics is on this account a science of human choices rather than a science of wealth is to confuse an aspect of the science with its totality." The last statement is especially difficult to understand. Is it not clear that the science of wealth is but a part of the science of human choice?[2]

In another footnote to my review, I said that Reisman rejects the time-preference theory of interest. In his reply Reisman tells us that he only rejects "the traditional version" of the time-preference theory. One might similarly say that Ayn Rand didn't reject altruism, only the traditional version of altruism. In another distinction without a difference, Reisman claims that he rejects the traditional theory not because it explains the rate of return in terms of goods (as I stated) but rather because it *fails* "to explain the rate of profit and interest in terms of money."

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[1]Reisman also creates confusion by introducing the classical concepts alongside the standard concepts as if they were alternatives (see pp. 152–53). Furthermore, on p. 152, Reisman refers to P as "the price." Elsewhere (for example, p. 560) he refers to P as the "price level" but there he gives the equation as $P=D_c/S_c$ where D_c is the monetary demand for consumer goods and S_c is the supply of consumer goods. If P is always meant to refer to the price level, as he claims in his reply, why the distinction between D and D_c and S and S_c?

[2]I did not mention in my review that by wealth Reisman means physical goods, which only makes his definition all the more odd.

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Readers can judge for themselves the uniqueness of Reisman's insights on national income accounting by comparing the quotations from Reisman with those of Rothbard and Skousen given in my review. Also, as I said in my review, Reisman's perspective on capital accumulation is essentially a modified version of Solow's growth model.

In my review, I praised many aspects of Reisman's *Capitalism*. I also pointed out that *Capitalism* has some errors and peculiarities. In his reply, Reisman found it necessary to focus on those errors and peculiarities. This is unfortunate, but does not detract from the better aspects of Reisman's book.

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FREE BANKING AND FRACTIONAL RESERVES: A COMMENT

PASCAL SALIN

The article by Jörg Guido Hülsmann (1996), "Free Banking and the Free Bankers," is an important contribution to a proper understanding of free-banking systems. He is perfectly correct in blaming some advocates of free banking who support arguments which are irrelevant or wrong, such as the argument according to which free banking makes possible a higher rate of investment, due to increased credits, the argument according to which a 100-percent-reserve system would imply higher costs, would impede financial intermediation, or would lead to money shortages, etc.

Thus, although I basically agree with Hülsmann when he blames both opponents of free banking and some free bankers who do not develop the right arguments, I cannot agree with his plea in favor of a 100-percent-reserve system. To be sure, one has the feeling that in such a system holders of money substitutes (notes or deposits) consider it a certainty that they can get the promised amount of money (gold) in exchange for their money substitutes, whenever they want. However, we also know that a situation of perfect certainty cannot exist. In any human system a certain degree of risk does exist and the perception of this risk by different individuals is normally different. Therefore, there is always a problem of the optimal distribution of risks between individuals with different risk perceptions and risk preferences. In a 100-percent-reserve system, for instance, there is not perfect certainty that money holders can get their money back, since the issuer of money substitutes may go bankrupt. Bankruptcy is caused by the fact that a firm is not profitable; and this may happen in a 100-percent-reserve system, since the issuing of money substitutes is costly (for instance printing the notes, replacing those which are used, investing against counterfeiting, protecting the gold deposited in vaults, etc.). One may even say that, in such a system, the issuer of money substitutes necessarily fails, except if it can find some means to make people pay for the services it offers them.

It may not be difficult to charge people for part of the *real* cost issuers of money substitutes have to bear: for instance, they may charge a higher gold price for notes

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when they sell them than when they buy them back to compensate for the cost of printing notes. But how to make people pay for the cost of gold storage? This cost is in fact proportional to the length of time which the gold-backed notes are held in the vaults of the issuer. Therefore, it would be rational for the issuer of bank notes to buy back its notes at a gold price which would decrease with time. But notes issued at different dates would have different gold prices and would not be perfect substitutes, so their liquidity would be lowered.

In a perfectly free banking system, everyone must be free to offer any type of notes and to charge customers for his services in any way he can imagine. And any customer must be free to choose the kind of notes and the system of payment for services he prefers. One possible way for the issuers of money substitutes to make people pay for the cost of holding gold is nothing else than a fractional-reserve system. In fact, in such a system, the return obtained by the issuer of money substitutes is proportional to the length of time during which people hold notes, since he receives interest on a fraction of the value of these notes, namely those which have credits and not gold as counterparts in his balance sheet. In a perfectly free banking system, different kinds of issuers, with different methods for charging customers, may (at least potentially) coexist on the market. But, we cannot decide from outside that a 100-percent-reserve system is optimal, since optimality cannot be defined independent of the wants of individual. By defending a 100-percent-reserve system against a fractional-reserve system, Hülsmann takes a constructivist position (which is contradictory to his anti-utilitarian orientation in other respects).

The very concept of a free-banking system—i.e., free competition between producers of money substitutes—is not compatible with the *a priori* idea according to which a 100-percent-reserve system *must* be the only acceptable system. Moreover, there are only two ways of selecting one or a couple of monetary systems (100-percent-reserve system or fractional-reserve system):

1. It may be imposed by state regulation, in which case, for instance, the state would forbid fractional reserves and would impose a 100-percent-reserve system. Apparently Hülsmann does not suggest such a selection process which would be totally incompatible with the concept of a *free* banking system.

2. The monetary system may be selected by the "market," which means that producers and users of money substitutes select one or a couple of monetary systems as the best means to meet their wants. If ever a 100-percent-reserve system is optimal—which means that it better meets the needs of producers and users of money substitutes—it will be selected, and fractional systems will not survive. But we cannot decide *a priori* that a 100-percent-reserve system is to be preferred; we have to experiment. It may happen that some people prefer a 100-percent-reserve system and others fractional systems, so that both systems coexist in a perfectly free banking system.

There is, therefore, some contradiction in the position held by Hülsmann. He is supporting the idea according to which a 100-percent-reserve system is optimal, but, apparently, he is not supporting a compulsory system by which fractional systems would be forbidden by the state. But if he was right about the optimal

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character of a 100-percent-reserve system, it is difficult to understand why the market would not select the optimal system. Moreover, according to Hülsmann, there would be a paradoxical situation in which competition would induce people to choose a fractional system and in which such a system would be ineluctably unstable and self-destructing. It is difficult to understand why, in the specific case of money, and only in this case, there would be any sort of market failure.

Hülsmann has another line of defense. He maintains that a bank developing a fractional system is fraudulent, since it is promising customers that it will redeem money substitutes for a fixed quantity of gold, and it is unable to do it. Some may deduce from this interpretation that the state is entitled to impose 100-percent-reserves, insofar as it would be in charge of preventing frauds. But is there really any element of fraud in a fractional-reserve system?

Let us in fact assume that, as a potential customer in a perfectly competitive monetary setting, I am offered the choice between two possibilities, namely holding notes issued by a producer under a 100-percent-reserve system or holding notes issued by a producer under a fractional-reserve system. Let us also assume that I have perfect information about the ways both producers operate. In the first case, I may have to pay for monetary services offered to me by the producer of money substitutes, or I may have to bear the already mentioned uncertainty costs implied by the low profitability of this producer. In the second case, I know that it may happen that I cannot redeem my money substitutes for money (gold). In both cases, the contracts I am signing with the producers of money substitutes are perfectly clear, and I have all the available information. If I decide that it is better for me to contract with the second producer and to bear the risk of illiquidity, I am totally responsible for this choice, and there is not the slightest element of fraud in the behavior of the banker and in our contract. I just prefer a certain structure of risks and charges over others and I decide that, from my own point of view—the only one to be considered—a fractional system is optimal. There is no justification for the claim of Hülsmann (or Murray Rothbard, or any other respectable economist) to decide on my behalf.

Even if we cannot demonstrate that a fractional system is preferable to a 100-percent-reserve system—anymore than Hülsmann can demonstrate the superiority of a 100-percent-reserve system—we get some information from history. In fact, the first notes were backed by 100-percent-reserves, but fractional systems emerged little by little, and there was certainly a period during which both systems were competing.[1] And fractional systems were selected not as a consequence of some state regulation forbidding 100-percent-reserve systems, but because they better met the needs of producers and holders of money substitutes.[2]

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[1] It seems that, before 1650, scarce commercial banks issued "notes" for deposits of metallic money. Later on, British goldsmiths and the Bank of Stockholm issued notes for commercial bills, thus opening the way for fractional reserves.

[2] Later on, as everyone knows, the state monopolized the production of money substitutes and made possible an indefinite expansion of money substitutes via a steady decrease in the reserve ratio. But this is a completely different story. In that case, fractional systems—and their

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Thus, let us assume that initially all monetary systems are based on 100-percent-reserves and that, little by little, they are transformed into fractional-reserve systems, just because these systems are preferred by the public and the money producers. It is quite true that, during the whole process of adjustment from one system to the other, there is a multiple creation of money substitutes, with all related effects (inflation, excess credits, over-investment, etc.). These effects are costly, but they may be viewed as a type of investment costs, those which have to be borne in order to shift from one given system to another preferred system. Now, these costs are only temporary costs (as any investment cost is). In fact, each issuer of money substitutes in a fractional-reserve system decides upon the reserve ratio which is viewed as optimal by him. By expanding the quantity of money substitutes beyond that point, the producer would increase unit gains, but he would lose the confidence of his clients and, probably, he would lose clients, which would imply a negative marginal gain.[3] In a fractional-reserve system, there is thus a long-run equilibrium structure of reserve ratios. As soon as all issuers of money substitutes have reached their optimal positions, there is no more multiple expansion of money substitutes. (Or, to put it differently, the rate of growth of money substitutes is perfectly equal to the rate of growth of money, i.e., gold.) It means that, contrary to what Hülsmann seems to suggest, there is no possibility for an indefinite expansion of money substitutes.[4] It is constrained by the amount of money (gold). If the possibility of an unlimited creation of money substitutes existed, it would mean that the free decisions of individuals, in a free-banking system with fractional reserves, would lead to a "socially" non-optimal situation, characterized by an excessive issue of money substitutes. By failing to distinguish between the long-run working of a fractional system and the (short-run) adjustment from a 100-percent-reserve system to a fractional system, Hülsmann suggests that a fractional system is costly and does not provide an optimal quantity of money.[5] But, as we stressed above, there is an over-expansion of money substitutes only during the intermediate period and the effects of this over-expansion can be interpreted as investment costs.

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actual workings—would have been adopted not because of their ability to meet the needs of individuals, but because of the possibility for the state to extract monopoly profits.

3Lawrence White (1995, pp. 141–42) perfectly explains why banks are not inclined to exceed this optimal reserve ratio.

[4]This was stressed by Ludwig von Mises, according to whom "Free banking keeps credit expansion within narrow limits" and, even, "within very narrow limits" (Mises 1949, p. 443). According to Philippe Nataf, statistics of the Massachusetts House and Senate show that bank credit expansion under free competition has been kept below 1 percent a year for more that five decades. One may also quote Murray Rothbard, who wrote that "if these banks are not to be based on 100-percent specie reserve, which Say indicates would be the best system, competition would keep (the banks) investing in sound, very short term credit which could easily be used to redeem their bank notes" (Rothbard 1996, p. 40).

[5]We certainly agree with him when he stresses that any quantity of money meets the needs of money users.

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Similarly, we cannot accept the idea expressed by Hülsmann according to which a fractional system is necessarily unstable and creates a systemic risk because of a contagion effect. According to him, whenever a sufficiently large bank goes bankrupt, the whole system breaks down. Such an effect may happen, but, contrary to Hülsmann's presentation, it cannot be considered as an inherent feature of every fractional system. In fact, the systemic risk depends on the precise institutional characteristics of the system. For instance, if the convertibility contract between a bank and its customer includes an option clause according to which the bank can suspend convertibility for a while, the holder of money substitutes does know in advance that there is a risk and that he may be obliged to remain in the position of a creditor of his bank longer than he would have expected. But an illiquidity crisis does not necessarily imply the failure of the bank (for instance if it has a high net worth and it can sell a huge amount of assets (Nataf 1993, pp. 97–106). And if it goes bankrupt, it may well happen that all holders of money substitutes finally get back the gold counterpart of their holdings.

Let us also imagine the case of a banking cartel in which all participants give convertibility guarantees for their own notes against the notes of others. These guarantees may be conditional, which means that whenever one bank is expanding money creation too much and there is a potential or actual risk of illiquidity, the other banks may suspend their convertibility guarantees. In such a case, there is a clear signal given to the market that all banks are safe except the one which, in fact, has been evicted from the cartel. Therefore, there is no reason for the holders of money substitutes issued by these banks to be anxious about their ability to meet their contractual obligations and there will be no run on their gold reserves. There may be a great number of institutional devices which may make the probability of systemic risk unimportant. As the owners of banks do not wish to go bankrupt, in a free banking system they would experiment with different institutional systems which might be able to avoid systemic risk. If there are several monetary cartels issuing various money substitutes and competing one with one another, they may develop different institutional systems and, little by little, the best ones will be selected. Therefore, there is no logical basis for claiming that an indefinite expansion of money creation is unavoidable in a fractional system. It all depends on the specific characteristics of the monetary system.

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FREE BANKING AND FRACTIONAL RESERVES: REPLY TO PASCAL SALIN

JÖRG GUIDO HÜLSMANN

Pascal Salin's (1998) critique of my article "Free Banking and the Free Bankers" (1996) raises several important issues about the theory of banking. However, I think that a closer look at them strengthens rather than weakens the case for a 100-percent-reserve system.

Salin claims that under 100-percent-reserve banking "there is not a perfect certainty that money holders can get their money back, since the issuer of money substitutes may go bankrupt" (p. 61). This observation is entirely correct. Yet no advocate of 100-percent reserves has ever claimed that this system would *exclude* business failures. The argument is that it leads to *fewer* bankruptcies than does fractional-reserve banking. The very existence of fractional reserves implies an additional source of bankruptcy, that is, a source of failure that is absent from 100-percent-reserve systems. For the same reason, Salin's statement that under 100-percent reserves "the issuer of money substitutes necessarily fails, except if he can find some means to make people pay for the services he offers them" (p. 61) is also true but irrelevant. For this is the *definition* of failure. *Every* business fails if the entrepreneur does not manage to make people patronize his services. No particular feature of 100-percent reserves is involved here.

On the problem of how a note-issuing bank can make people pay for the cost of gold storage, Salin states that "notes issued at different dates would have different gold prices and would no more be perfect substitutes, so that their liquidity would be lowered" (p. 62). It is true that 100-percent reserves would *in praxi* mean that most small and medium-size payments would be effectuated in specie and that most people would store their money by themselves rather than pay banks for storage services. Salin's observation suggests that bank notes would, in most cases, be used only once and only for large-scale payments. Yet is there really any problem involved? Is it an end in itself that bank notes be used? Only if this were the case would Salin's objection hold true.

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I do not think that the use of bank notes could ever be justified as an end in itself and that, therefore, the real issue is *how many* bank notes should be used. Now, what is the standard of reference by which one can discern the *right* quantity of money substitutes? I submit that there is but one possible standard, namely, to accept the decisions of the money owners. Whatever quantity of notes is issued on a 100-percent-reserve basis is, *ex ante* at least, the right or optimal quantity. If one violently prevents the banks from issuing this quantity then this would be a case of forced disassociation. And if a fractional-reserve system were imposed on the market participants, this would then be a case of forced association.

Salin's point of view is a different one. He claims that "optimality cannot be defined independently of the wants of individuals" (p. 62). However, this standard of reference is conceptually meaningless and practically irrelevant since it presupposes that inter-individual comparisons of utility are possible. The problem is that the wants of individuals can be contradictory. My preference is that my banker does not lend out my money holdings to other people. My banker's preference is precisely the opposite. What, then, is the right decision to take on the basis of the "wants of individuals?"

Salin might respond that whether my deposits are 100 percent covered or not is a matter of agreement between my banker and me. Yet in taking this stance he would admit that property, not wants, is the real standard of reference to which the optimality of a system must be gauged. And this is the whole point that the opponents of fractional reserves are trying to make. They do not decide "*from outside* that a 100-percent-reserve system is optimal." Rather, they judge the matter from the only possible point of view, namely, from the standpoint of voluntary agreements between property owners. Because this is the point of view that any participants in this debate implicitly adopt, it is senseless to accuse me of "constructivism." True, it is a form of "constructivism" to advocate the establishment and maintenance of property rights because there is another logical possibility, namely, to advocate a system of catch-as-catch-can. However, there is no such thing as society and markets outside a framework of private property. And whoever sets out to discuss problems that can only emerge within society (for example, problems of banking) takes private-property rights for granted. The very fact that Salin analyses banking problems implies that he too adopts a "constructivist" position. But whereas mine is a coherent constructivism, his is contradictory.

With this in mind, it is easy to answer the question whether the market would select a 100-percent-reserve system. Because this banking system is the only one that conforms to the fundamental condition of any market, namely, respect for private-property rights, there is a market in banking *only if and insofar as* all money substitutes are covered 100 percent. In short, it is meaningless to talk about a "market" that selects fractional-reserve banking. One could as well claim that the market selects robbery to acquire cars or that it selects murder of present jobholders or tenants to get their jobs or apartments. People might choose very bad ways to acquire the goods that they desire, but only if and insofar as they

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choose to respect their fellows' property can they be said to interact within a market framework. From this it follows that we do not have to make experiments to know what a market in banking would be like in this respect.

A real market in banking *implies* 100-percent reserves. The fact that people have an incentive to use fractional-reserve banking is no more surprising than the fact that robbers have incentives. It is not competition (which presupposes private property) but malice or ignorance that induces people to choose a fractional-reserve system. And the fact that in the real world both fractional- and 100-percent-reserve banking might coexist is due to the same reason that tax-financed production might coexist with production that is exclusively financed by private patrons. Such coexistence merely displays the moral condition and the degree of enlightenment of the population. The instability of fractional-reserve banking is an emanation not of market failure but of moral and intellectual shortcomings.

Even in historical retrospect, Salin's contention that "fractional systems were selected not as a consequence of some state regulation forbidding 100-percent-reserve systems, but because they better met the needs of producers and holders of money substitutes" (p. 63) is questionable. The fact is that in the early nineteenth century, British and American courts ruled against 100-percent-reserve banking in a series of important decisions: *Carr v. Carr, Devaynes v. Noble,* and *Foley v. Hill et al.* The courts ruled that bank deposits were not bailments but credits to the banks (Rothbard 1983, pp. 93ff; 1994, pp. 42f). The consequence was that, rather than seeing the bankers as embezzlers (criminals), the depositors were depicted as bad investors. These decisions, instances of state intervention in the market economy, were crucial for the modern history of banking. One might object that even private courts could have taken these decisions. My response would be that it does not matter how violations of property originate. If and insofar as property is violated there is no market.

Salin seems to misunderstand my argument against the feasibility of fractional-reserve banking. I do not claim that fractional-reserve banks can indefinitely increase their issues of fiduciary media or that there is no "optimal position" for them to reach. My point is that the banks do not *know* this optimal position and that, whereas this is admittedly a problem of all business, only in fractional-reserve systems does bankruptcy of one bank lead to the contagion-induced failure of all other banks. The conservative banking cartels that Salin describes might *delay* the breakdown of the whole system, but they cannot prevent it.

The decisive fact is that operating on a lower reserve ratio is a competitive advantage. Salin does not deny this point. Yet once it is conceded, one must admit that this advantage can only be for some time *counterbalanced* by the verdict of established and more conservative banks. But what happens if a long-since established bank, which has accumulated confidence capital over decades, announces that it will decrease its reserves? And why should this take so long in a truly free market? Today's experience can hardly tell us how dynamic a competitive banking system would be because we know the bureaucratic remnants of what were once banks.

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Neither do option clauses change the imminent threat of contagion crises. They have the same effects as the introduction of central banks, namely, to provide temporary Band-Aids that do not remedy the fundamental disease. If the customers accept option clauses, the banks can issue ever more fiduciary media. Thus, the same old problem of bankruptcy and contagion emerges on a larger scale. It is also wishful thinking to indulge in the "high net worth" of a bank, which "can sell a huge amount of assets" (p. 65). How much the bank is worth and whether its assets are huge or tiny depends on the money prices paid on the market. If people do not trust fiduciary media anymore and there is a run on the banks to reclaim their money, then the quantity of money in the larger sense (which determines the height of money prices) shrinks within a second. And with it shrink the assets of the banks and their net worth is reduced to a fraction of what the bankers believed it to be. *This* is how a crisis works out. Today the central banks prevent such things at the cost of still more inflation (and regulation). Yet this should not delude us about the nature of fractional-reserve systems.

According to Philippe Nataf, whom Salin quotes, early-nineteenth-century, fractional-reserve banks in New England were spared from contagion crises. However, from this one instance we cannot infer that this system was stable *because of* the bank reserves being fractional. Theoretical insight suggests that these banks operated smoothly *despite* their adoption of the wrong system. Other factors (for example, the conviction that more than 30 percent of uncovered bank notes were "unsound") must have more than counterbalanced the negative influence emanating from the fractional reserves and thus prevented those exaggerations that precipitated banking crises in other regions.

Let us finally deal with the question of whether fractional-reserve banking is an instance of fraud. Salin discusses this problem from the point of view of someone who is offered fiduciary bank notes. In his eyes, the problem boils down to a choice between two risk-chance positions. There can be no question of fraud as long as contracts are voluntary:

> If I decide that it is better for me to contract with the second producer [offering fiduciary media] and to bear the risk of illiquidity, I am totally responsible for this choice, and there is not the slightest element of fraud in the behavior of the banker and in our contract. (p. 63)

Now, at first glance it seems as if, from the point of view of this person, there is really no problem involved. Yet consider the case of a receiver of stolen goods. Would Salin go so far as to assert that it is just a question of risk and chance whether one should buy from him or from a rightful owner of that kind of good? Obviously, the moral case for fractional-reserve banking relies on an affirmative answer to this question. I need not dwell on the fact that there could be no civilization if this were a generally accepted doctrine. The fundamental fact is that freedom of contract already presupposes property rights and the respect of property rights. As Hans-Hermann Hoppe has lucidly stated:

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> Freedom of contract does not imply that *every* mutually advantageous contract should be permitted. Clearly, if A and B contractually agree to rob C, this would *not* be in accordance with the principle. Freedom of contract means instead that A and B should be allowed to make any contract whatsoever *regarding their own properties*, yet fractional-reserve banking involves the making of contracts regarding the property of third parties. (1994, p. 70)

In other terms, he who accepts fiduciary media does *not* "bear the risk of illiquidity" and he is *not* "totally responsible for this choice." The bank customer fraudulently socializes the risks of his activity and the responsibility for his choice. To challenge this critique, Salin would have to focus on a slightly different case. Assume that you own a sum of money and that you have the choice to deposit your property either in a 100-percent or in a fractional-reserve bank. Is it not entirely up to you to choose the second alternative? And if you do so, would it not be entirely proper behavior on the part of the banker to create fiduciary money substitutes, using your money as backing? It seems to be difficult to deny this. Yet problems arise as soon as one takes a closer look at this "contract" with the fractional-reserve bank. What precisely is it about? The astonishing answer is, *one cannot tell.* For in fractional-reserve banking, all customers have the right to use the same deposited money. The owner may withdraw his deposit at any time, and the banker may use it during the whole time until it is withdrawn. This clearly contradicts the very idea of contracts, which is to determine who, and at which time, has the right to use a given object. Both the customer and the banker, in their dealings with other market participants, represent themselves as the owners of the deposit. Their "contract" implies that two titles for one and the same property are now used in market exchanges. This is a clear instance of fraud (Hoppe et al. 1998).

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Risk and Business Cycles: New and Old Austrian Perspectives. By Tyler Cowen. London: Routledge, 1997

This very ambitious book starts with the high promise of a radically new and superior theory of business cycles, but when it ends the reader cannot resist the conclusion that the promise has gone unfulfilled. Tyler Cowen states his goal quite explicitly. He finds the "traditional" or "old" Austrian theory of business cycles (hereinafter ABC) to be inadequate and outmoded. Nevertheless, Cowen sees merit in certain aspects of ABC, such as capital goods' complementarity and the importance of intertemporal coordination. Therefore, he offers a "new" Austrian approach whose elements include rational expectations, real business cycle theory, and sectoral shifts, and whose organizing motif is the role of risk in entrepreneurial decision-making. This alternative, risk-based theory of business cycles (hereinafter RBBC) is presented by Cowen as a sophisticated and improved version of the "naive" ABC. It is the result of "grafting rational expectations and modern finance theory onto the original Austrian theory" (p. 10). If such a procedure sounds unsavory and unlovely, I can assure the reader that the resulting amalgam is little better.

The book is divided into five chapters. The first is an introduction in which Cowen names the deficiency he is trying to improve upon: "the traditional Austrian approach fails to establish its central contention—the link between positive rates of nominal money growth and excessive capital-intensity" (p. 2). He then defines what he means by investments that are risky. These are "long-term, costly to reverse, high-yielding, and having returns highly sensitive to the arrival of future information" (p. 3). Malinvestments occur when "entrepreneurs earn less than the risk-free (or minimum-risk) rate of return" (p. 7). Cowen further stipulates under what assumptions his RBBC will be developed. They include expectations that are rational in the sense that errors are serially uncorrelated (although he rejects the idea of strictly homogeneous information), constant returns to scale, perfect competition in all sectors, and perfectly flexible wage rates and prices. He even reveals a capsule version of one of the key conclusions to be found in later chapters.

That is, contrary to ABC, inflation does not systematically lead to unsustainable malinvestments and a boom-and-bust cycle. Sometimes monetary policy produces *sustainable* expansions; "the final outcome is never certain in advance" (p. 4).

Chapter 2 is devoted to a discussion of RBBC in real terms, as opposed to nominal or monetary terms. Here Cowen claims that his approach represents a kind of middle ground between ABC, which interprets cycles as driven by

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entrepreneurial errors, and so-called real business cycle theories, which insist that cycles are driven by technology shocks. The common thread, per Cowen, is the reaction to risk on the part of entrepreneurs. The extent to which investment is undertaken can be affected either by exogenous events such as unexpected changes in a central bank's monetary policy or by endogenous events such as credit rationing, shocks to retained earnings, the arrival of new information, or sudden shifts in entrepreneurs' preferences regarding risk exposure. When discussing the latter, he even utilizes Keynes's notion of "animal spirits" (p. 25). The list of possible precipitating factors is quite long. Indeed, when reading this chapter, I got the unsettling impression that to Cowen's mind virtually *anything* can bring about a business cycle.

There are at least two assertions in Chapter 2 that are sure to rankle most Austrians. First, Cowen confirms quite candidly what a reader will quickly come to suspect. That is, RBBC sees business cycles, at least in part, as evidence of *market failure*, not merely as an aberration imposed on an unsuspecting economy by an intrusive central bank. With RBBC, "all business downturns indicate a market failure, even if the government causes the relevant negative shock" (p. 15). Second, focusing on Hayek's work on cycles, he claims that ABC fails to address the issue of "comovement," that is, the observed general expansions or contractions of activity across many sectors of the economy. Apparently Cowen interprets ABC as dealing exclusively with the shifting of resources from consumer goods production to capital goods production, or *vice versa*. Thus he questions how such intersectoral resource movements can lead to the phases of the business cycle.

Chapter 3 elaborates further on this RBBC, primarily in the context of two basic monetary scenarios. The first is an increase in the rate of growth of the monetary base that lowers real interest rates and thus precipitates a typical boom-and-bust cycle. The second is an increase in "monetary uncertainty or volatility" that throws the economy into a recession without first experiencing an expansionary period. According to Cowen, the former occurs unambiguously only if such monetary growth does not also involve an increase in volatility. If it does not, then entrepreneurs will be induced to invest in longer-term, more capital-intensive, and thus allegedly riskier, projects. Since these are highly sensitive to new information, some entrepreneurs' expectations will be foiled as time passes, and these projects will prove unprofitable. Bust follows boom. In the latter scenario, monetary volatility rises, but presumably not the average rate of monetary growth. This discourages investment in longer-term projects, because it increases perceived risk; growth rates decline; and the economy descends into a recession without a preliminary expansion.

What about the very plausible case in which the rate of monetary growth both rises and becomes more unpredictable? In RBBC, the result is indeterminate, because two opposing forces are at work. "The net effect will be uncertain, and long-term investment may either contract or expand" (p. 46).

This chapter also presents Cowen's views on some of the issues surrounding (a) credit rationing, (b) alternatives to discretionary monetary policy, and (c) the

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non-neutrality of money with respect to capital markets. If creditors respond to changes in monetary policy by varying the quantity of funds loaned, but not necessarily the rate of interest charged, then the basic, positive relation between money and investment probably still holds. *Ceteris paribus*, monetary growth encourages investment and tends to increase the cyclicality of the economy.

Regarding monetary rules, Cowen finds none to be a simple solution to business cycles. He assumes throughout that the key relationship is between the monetary base (rather than some broader monetary aggregate) and business investment. Any regime that includes a central bank allows for the possibility of monetary base manipulation. Thus, he concludes that price-level rules, nominal GNP targeting, nominal interest rate targeting, commodity currencies, and even 100-percent-reserve banking all may fail in a central banking context. Does this then imply that free banking, with gold as the base money, must be the answer? No, according to Cowen, because even though free banking exhibits automatic restrictions on overexpansion of the (inside) money supply, it does "not necessarily stabilize the marginal cost of producing gold" (p. 57).

Although he gives lip service to both Ricardian equivalence and the Modigliani–Miller theorems concerning monetary policies that do not involve fiscal changes (pp. 68–70), Cowen nevertheless agrees with Austrians and other economists who insist that changes in monetary policy are *not* neutral with respect to real economic variables. "[W]e should think of monetary policy as a real sectoral shock, rather than as a purely nominal event" (p. 64). However, when discussing whether long-term interest rates as well as short-term rates will be affected by a given change in monetary conditions, he once again hedges his bets. Everything "depends on expectations" (p. 74) in that investment decisions may hinge on whether the change in short-term rates is expected to be temporary or permanent.

Chapter 4 will probably garner more attention from Austrians than any of the other portions of this book. It is here that Cowen describes, analyzes, and strongly criticizes what he takes to be the traditional Austrian explanation of business cycles. He portrays ABC as an approach that "views investment as the transmission mechanism for the cycle, starts with the assumption of full employment, links the monetary and real sectors of the economy, uses a loanable funds theory of interest, and builds on Wicksellian themes" (p. 76). The representative expositors of ABC he apparently takes to be Mises, Hayek, Rothbard, and Garrison (pp. 10, 76). Although Cowen is critical of several prominent features of ABC, the one feature with which he is most preoccupied is the posited expectations of entrepreneurs.

Cowen argues that ABC assumes both that entrepreneurs mistake monetary inflation for an increase in voluntary savings and that entrepreneurs mistakenly think that the observed decline in real interest rates will prove to be more or less "permanent." He rejects both as implausible. Indeed, he offers eight detailed reasons why he thinks they should be rejected (pp. 80–100). These include the assertions that private savings do not exhibit the volatility implied by ABC, constant nominal money growth may make newly undertaken investments

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sustainable in the long term, current real interest rates do not provide reliable information about future commodity demand, and lower real interest rates may be the result of a decline in loanable funds *demand* rather than an increase in the *supply* of loanable funds. The two signal extraction problems associated with ABC he then contrasts with a third type in which economic agents fail to distinguish nominal price effects from real price effects. This last type he correctly identifies as being central to the models of certain New Classical theorists such as Robert Lucas (p. 79).

Cowen's assessment is that the "Austrian theory does not follow directly from the ability of inflation to distort market price signals, or from the injection of new inflationary funds into the loanable funds market" (p. 101). His own, risk-based, approach allegedly avoids the implausible assumptions of ABC and thus offers a superior theory at the same time that it exhibits a degree of eclecticism which brings it closer to neo-Keynesians, modern monetarists, and real business cycle theorists (pp. 2, 104).

Chapter 5 is composed entirely of a survey of recent econometric work on various aspects of business cycles and related monetary issues. The chapter does not, contrary to what one might suppose, present Cowen's testing of some formal model of his own creation. The studies that he catalogues are so diverse, and the results so mixed, that they are quite difficult to summarize. However, in very rough form, Cowen finds at least some support for the propositions that (a) money growth does affect real interest rates and brings about intersectoral resource shifts, (b) changes in uncertainty affect aggregate investment, (c) capital-intensive industries often experience greater cyclicality than other industries, and (d) monetary inflation can increase the riskiness of bank loans. Does any of this unambiguously imply the superiority of either ABC or RBBC? No. And amazingly enough, Cowen admits it. "None of these results, however, discriminates decisively in favor of risk-based (or traditional Austrian) theories as opposed to other potential business cycle mechanisms" (p. 149).

A Good Effort Gone Wrong

This book possesses some virtues. The subject of business cycles is certainly important enough to justify a book-length treatment, and I would give Cowen high marks for a brave assault on a difficult topic. His risk-based approach, although I believe it to be fatally flawed, is innovative and challenging. Moreover, unlike most economists, he treats the traditional Austrian theory with seriousness and attempts to grapple with its principal features. In addition, it is clear that Cowen is familiar with a wide range of research on business cycles and on certain related issues in monetary and capital theory.

On the other hand, this work is disfigured by a number of errors and deficiencies. These might be categorized under the two broad headings of (a) problems of content and (b) problems of style or exposition.

Allow me to begin with the content of the book. Most fundamentally, Cowen argues that ABC, though not without some merit, suffers from certain mistakes

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that his RBBC avoids. Therefore, RBBC is supposedly superior. But does Cowen accurately portray ABC? No, he does not. I will give just a few of the more glaring misstatements to be found in the book (there are more). Cowen repeatedly states that ABC focuses on low real rates of interest that are brought about by positive rates of monetary growth. In fact, ABC focuses *not* merely on historically low rates of interest, but on rates that are *lower than the natural rate* (Mises 1966, pp. 558–59; Rothbard 1970, pp. 862–63; Garrison 1989, p. 22). It is that inconsistency between the rate in the market for loanable funds and the (natural) rate which reflects individuals' time preferences which lies at the heart of ABC.

Moreover, it is not just *any* monetary increase that can precipitate a cycle per ABC, but only that which involves an expansion of credit in the form of new business loans (Rothbard 1978, p. 152). If Cowen had kept this in mind, it might have prevented him from wondering why ABC assumes that a lower market interest rate must be the result of an increase in the supply of funds rather than a decrease in the demand for funds (pp. 85 and 101). Of course, remembering that time preferences have not changed would also help in this regard, but then Cowen dismisses the concept of time preference (along with the natural rate of interest, the Ricardo effect, and forced savings) as worthless (pp. 65, n. 11, 95, 105–8).

Cowen declares that ABC offers no explanation for "comovement," the expansions and contractions of both capital goods and consumer goods. That is simply false. ABC explicitly argues that, as interest rate signals induce entrepreneurs to invest in a more roundabout production process, capital goods production "booms" and persons involved in capital goods industries enjoy higher incomes. Since time preferences have not changed, those increased incomes will predominantly be spent for *consumer goods*; therefore the demand for, and the quantity supplied of, consumer goods will rise. In short, dollar expenditures for both capital goods and consumer goods will rise, though not strictly simultaneously. Eventually, the rising costs of production reveal that many of the projects which have been undertaken are, in truth, unprofitable, and the recession ensues. Incomes fall in capital goods industries, and this spills over into reduced demand for, and quantity supplied of, consumer goods (Mises 1966, pp. 552–54; Rothbard 1970, pp. 854–59). Contrary to Cowen, ABC offers a lucid and temporally sophisticated explanation of why both the general expansion and the general contraction occur.

In addition, Cowen portrays ABC as starting from the assumption of full employment in the economy (p. 76). According to Rothbard, this is a common criticism of ABC, but nevertheless incorrect. Credit expansions always generate cyclical effects "whether or not there are unemployed factors" (Rothbard 1970, p. 866).

Even setting aside the abovementioned misunderstandings of ABC, this book still has problems. Perhaps the most fundamental of them all is the very use of the concept "risk." It is not entirely clear what Cowen has in mind. On the one hand, he wants quite badly to link RBBC to certain features of modern finance theory such as mean-variance analysis and the capital asset pricing model (CAPM).

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There, risk refers to the variance of the probability distribution of past returns on some existing asset. It involves historical data and is quantifiable. On the other hand, he insists that his primary concern is with the entrepreneurial choice of whether to invest in new long-term or new short-term projects. In that case, whatever project is selected will represent a unique event, and there are *no historical data* upon which to draw. Strictly speaking, no probabilities can be calculated (Mises 1966, pp. 106–16). Here, the entrepreneur faces *uncertainty* rather than risk. Is it possible that Cowen is unaware of this potentially critical distinction?

It is also troubling that Cowen assumes longer-term projects are necessarily "riskier" than shorter-term projects. He does grant the possibility that the reverse could, in theory, sometimes be the case, but rejects it as "the exception" (p. 23, n. 5). Of course, this assumption is essential to RBBC, because without it there would be no systematic way to connect "risk-taking" to the capital structure. A similar difficulty arises with the possibility that some entrepreneurs may, under some conditions, be "risk-seekers" rather than being unfailingly "risk-averse."

One would even be justified in asking if RBBC really represents a theory of cycles at all. I say that because the text is peppered with statements of the form, "If X increases, Y might either increase or decrease." Perhaps that is why no formal model is offered: Cowen could not unambiguously specify the algebraic signs of the parameters involved.

Finally, the assumption of rational expectations as an integral part of RBBC must be called into question. Cowen admits that this assumption does not accurately describe the real world, but retains it anyway based on the belief that it is "a useful form of discipline" (p. 8). I would have thought that *reality* was the most useful of all forms of discipline; but Cowen prefers to assume rational expectations, because he believes this assumption forces the analyst to specify the "explicit informational asymmetry" that leads to entrepreneurial errors (p. 8). Odd that Cowen later castigates Austrians for being overly specific about the informational asymmetry between entrepreneurs and the central bank regarding those credit expansions which bring about the boom and bust cycle (pp. 80–82).

I will be mercifully brief with my comments about the writing style encountered in this book. Such mercy is motivated by the fact that, with reluctance, I must admit that the writing is rather uniformly awful. Far too much of the book reads like a series of "laundry-lists." There are eight reasons for rejecting ABC, six assumptions of RBBC, eight stylized facts about cycles, thirteen postulates of ABC, seven empirical questions involving cycles, and so forth. The presentation is often clumsy and pedantic; there is no grace or elegance of exposition. Some will say that is excusable in an academic and technical work, but I still prefer economists who can write.

It is difficult to imagine that the audience for this book will be large. Austrians will quarrel with Cowen's basic premise that ABC is decidedly deficient and needs to be replaced. Monetarists, New Classicals, neo-Keynesians, and real

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business cycle theorists will probably be disappointed by the absence of any formal models. Only the few who are particularly keen to read everything available on business cycles are likely to struggle through this book.

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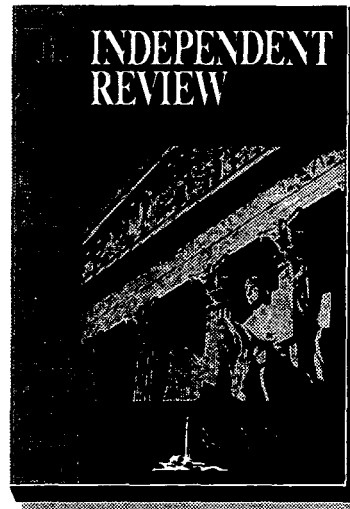

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Neoclassical Microeconomic Theory: The Founding Austrian Version. By A.M. Endres. London: Routledge, 1997

A.M. Endres states, on the opening page of his book, his intent is to "investigate the ways in which the [founding] Austrians were developing an essentially unified project which was different from other founding neoclassical branches of economics." Such a statement implies three aspects of founding Austrian economics to be examined: (1) Austrian economics as an element in the broad neoclassical program; (2) Austrian economics as distinct from the other branches of this program; and (3) Austrian economics as unified in its distinctiveness. While it is the first of these propositions that will probably generate the most controversy within some Austrian circles, it would be to the detriment of scholarship in the history of Austrian economic thought if this aspect were emphasized at the expense of the other two. For Endres has done an adequate job of highlighting elements of distinctiveness and similarity among the founding Austrians (Menger, Wieser, and Böhm-Bawerk) which go beyond the cut-and-dried methodological issues emphasized by later Austrians.

In fact, very little of Endres's book is concerned with defining the place of the early Austrian economists within the neoclassical program. Such emphasis is to be found only in the first chapter, in which the classification of the founding Austrians within neoclassicism does not go far beyond identification with the common thread of a utility theory of value coupled with an essentially "marginalist" perspective. Endres briefly considers alternative definitions of neoclassical economics (pp. 3–6), including the "exchange-oriented" definition of Sir John Hicks (within which the Austrians certainly fall) and Philip Mirowski's characterization of neoclassicism as essentially "linked to the rise of energetics in the physical sciences" (from which the Austrians are rightfully excluded). In the end, Endres comes to the conclusion that recent economic historians have correctly located the early Austrians within the neoclassical movement, although not squarely in its mainstream.

The remaining chapters focus on various elements of distinctiveness in the writings of the founding Austrians. Five categories are identified in which Austrian views demonstrated what Endres calls "enduring continuities": conceptions of economic science, economizing behavior, price formation, competition, and capital-and-distribution theory. Endres provides detailed analyses of the writings of the founding Austrians on each of these subjects, pointing out differences as well as similarities in their respective treatments, and paying particular attention

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to the often implicit assumptions made by the writers. The list of categories is not exhaustive—there is little doubt that other categories of "enduring continuity" could have been identified—but these five offer the reader a flavor of the early Austrians' unique vision of economics.

Regarding the founding Austrian conceptions of economic science, Endres presents a viewpoint that is much different from that offered by the more contemporary Austrians. In particular, the early Austrians were much more eclectic in their ideas on both the nature and conduct of economic science than their later counterparts have been. For instance, Menger "feared the preponderance of 'one-sided attitudes'" (p. 13) in the field of political economy, which he viewed as containing three main branches: an historical-statistical branch, a theoretical branch, and a practical or applied branch. Furthermore, he subdivided the theoretical branch into "exact-theoretical" and "empirical-theoretical" components, with the former yielding strict logical propositions (if A and B then C) and the latter yielding generally observable (empirical) propositions (if A and B then *usually* C). Menger insisted that only a combination of these types of theoretical reasoning "would 'procure for us the deepest theoretical understanding' of economic phenomena" (p. 15).

Another element of the early Austrians' conceptual framework, and one that continues to differentiate the Austrian paradigm to this day, is the emphasis placed on "introspective" methods of economic theorizing. While Menger stressed in his debates with the German historicists that political economy included all of the various branches outlined above, it is clear that he was primarily interested in developing the theoretical branch in his work. The task of *exact* economic theory, according to Menger, is to trace the "complex phenomena" of economic relations back to their "psychological causes or to ultimate component elements" which were "accessible to perceptual verification" (p. 14). Wieser expanded on this Mengerian insight when he considered the nature of the "psychological" orientation of economic theory, which he described as based on introspection, or "observations concerning the inner life of man" (p. 16).

Endres goes on to analyze the early Austrian considerations of economizing behavior and choice, and again reveals a surprising emphasis on eclecticism within these writings. All three founding Austrians provided foundations for a broader analysis of choice, making use of interdisciplinary perspectives borrowing from psychology, biology, and ethics in order to gain insights into valuation, the formation of needs (or wants), and the like. Menger went so far as to suggest that the theory of needs is "the bridge that leads from the natural sciences, especially biology, to the social sciences" and that it could be suggestive of "a difficult and previously unexplored field of psychology" (p. 36)—in stark contrast to later Austrians and neoclassicals who considered such lines of investigation as being completely devoid of economic content.

The Austrian focus on dynamic processes rather than on static equilibrium features prominently in the discussion of early Austrian views on price theory and competition. A particularly useful application of this dynamic approach is

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illustrated in the founding Austrian considerations of the competitive process. Competition implies an absence of equilibrium in markets, and thus is characterized by conditions of rivalry in bidding between agents rather than by a theoretical end-state. In contrast, monopolistic conditions refer to a point in time—they are by necessity a description of a particular state of affairs. It is therefore possible (and vital) to discuss the process of competition regardless of whether conditions approximating "perfect" competition hold or not, for it is entirely consistent to speak of competition even in the presence of monopolistic conditions. In fact, the competitive process involves attempts to erect monopolistic barriers to competition (as emphasized so successfully by Schumpeter).

These and other aspects of the early Austrian analyses of price formation and the competitive process served to provide foundations for important work by later Austrians, such as Hayek and Kirzner, on the nature of competition and entrepreneurship. Endres notes, for example, that Hayek's development of the knowledge-acquisition problem is foreshadowed by Menger and Böhm-Bawerk, while Wieser demonstrated awareness of the role of competition in enabling calculation and the coordination of plans. Thus, although some scholars have described the insights of later Austrians as developments of classical economic ideas, the more immediate and relevant influences stemmed from a rich tradition formed by Menger, Wieser, and Böhm-Bawerk.

The primary weakness of Endres's book is the author's tendency to occasionally diverge from analysis of the distinctive and unifying elements in early Austrian thought and dive instead into pseudo-theoretical criticism of particular concepts. Nowhere is this tendency more pronounced than in the chapters covering capital and distribution, although there are traces of it throughout the book. Perhaps Endres feels inclined to make clear his subjectivist credentials by presenting these criticisms, but he adds very little of substance to the debates mentioned. It would have been preferable if he had omitted these diversions and concentrated his efforts on defining even more clearly the unique role played by the founding Austrians in the development of economic science.

In sum, this is not a great book, but it does an adequate job of performing the tasks for which it was intended. Despite a few instances where his writing becomes somewhat labored, Endres has managed to bring together many strands of research and organize them into a fairly coherent whole. This is certainly a book that will be of interest to serious students of early Austrian thought.

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Against Politics: On Government, Anarchy, and Order. By Anthony de Jasay. London and New York: Routledge, 1997

This is a wonderful collection of previously published articles by Anthony de Jasay who, it turns out, is an undiscovered Austrian, or at least a close cousin. The essays in *Against Politics*, published between 1989 and 1996, are united around a common theme, the economic and political aspects of government and "ordered anarchy." The book is full of sparkling insight and penetrating, calm dissections of pro-state arguments. Opponents of the state will find much ammunition here. Statists (even of the minimalist variety) will find much to ponder.

Jasay's arguments pack quite a punch, and make it clear that he is a powerful, careful scholar. He also appears to be a quasi-Austrian economist and political theorist, which is surprising given that he does not appear to be very familiar with the work of Austrian theorists, such as Mises and Rothbard. Has he even read *Human Action*? One wonders. The primary well-known Austrians he cites are Hayek and Wieser, who represent the "Vienna School" (p. 162) instead of the Austrian School. He has apparently come to many Austrian conclusions without the benefit of much exposure to Austrianism. For example, he makes good use of the observation that not only is utility not measurable, but interpersonal utility is also completely incommensurate (see, e.g., pp. 81–81, 92, 98, 144). He even writes that, "[u]nlike the physical sciences, inference presupposing purposiveness is proper to the study of reasoning beings and cannot be avoided without inordinate loss of content" (p. 74), which bears an uncanny similarity to Mises's own epistemology (Mises [1949] 1966; 1962; 1981).

The book is divided into two parts. The seven chapters of Part 1 are critical of statism, the view that political action is necessary, efficient, or desirable. In the four chapters of Part 2, our author somewhat tentatively proffers his own politico-economic theories, designed to show that various desirable social institutions are possible without political arrangements. The essays are well-ordered and generally fit together almost as well as chapters of an integrated work, although, as is to be expected in a collection of this kind, there is some repetition and redundancy. (A useful summary of the book's themes, structure, and arguments is found in the Introduction, at pp. 4–7.)

Jasay, like Austrian David Gordon, is a master of criticism.[1] A standard technique is to hold a statist's logic up to standards that the statist himself espouses. In a

[1] It might be interesting to see the two review each other's work.

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rare personal glimpse, he reveals an instance of applying this technique in his own life:

> The present writer, when a subject of a "people's democracy" [presumably the author's country of origin, Hungary], used to taunt his political masters that capitalism had never existed anywhere, that it was yet to come, it was the "wave of the future"—a taunt that reduced them to fury but naturally failed to provoke any refutation. (pp. 108–9)

Given his powers of criticism, the critical pieces in Part 1 contain stronger arguments than Part 2, although for some (such as this reviewer), the essays in Part 2 will still be of at least as much or more interest. For although his positive theorizing is weakened by his own moral skepticism (more on this below), it is strengthened by his critique of statist alternatives; further, his basic intuitions and premises are largely sound. Combine this with a multitude of keen insights and critiques of opposing social theories, and Part 2 is of immense interest, even with its deficiencies.

Part 1 opens with "Self-Contradictory Contractarianism," which addresses the argument that various "intractable" problems of the state of nature, such as prisoner's dilemma and free riding (pp. 11–12), prevent systematic social cooperation. One way out of these dilemmas would be to make "binding" contracts. However, people cannot make binding contracts in the state of nature, since rational actors without fear of sanction will always default, thereby making contracting impossible and requiring the state to provide an effective contract enforcement mechanism.

But, Jasay asks, "if contracts require an enforcer, how could there be a social contract creating an enforcer without *its* enforcement being assured by a meta-enforcer created by a meta-social contract, and so on in an infinite regress" (p. 5). Jasay recognizes that the proposed solution assumes that the state can act as an "enforcing agent acting as a programmed automaton" (p. 19). Yet this is to "assume away the principal-agent problem" (ibid.), since the state has little reason to restrict itself to enforcing the contract. For these and other reasons, "[t]here is . . . no contractual exit from the state of nature: if the state is to be created by contract, it cannot be created, since it is its own antecedent condition" (p. 22). Thus this particular ground for the necessity of the state contradicts itself, and advocates of government are hoist by their own petard.

Jasay correctly recognizes that the real question is whether ordered anarchy (what we would call anarcho-capitalism) is possible or not, and this question "ultimately boils down to the issue of the enforcement of mutual promises without a final specialized enforcer" (p. 29). Jasay seems at home with the somewhat dubious field of game theory, but this helps to make him especially suited to criticize its irrelevance to the actual world. He argues that typical game-theoretical arguments are unrealistic and inapplicable to real-life situations, since "[a]nyone who has a name, lives in a place, does something for a living—that is, anyone tied into the fabric of society—would think twice before treating mutual promise as the single-play prisoner's dilemma says he must" (p. 33). We can,

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therefore, expect that contracts can be self-enforcing, without the aid of a centralized enforcing agent, and thus at least some of the dilemmas that are claimed to be part of anarchy are chimerical.[2]

Indeed, as argued in chapter 2, "Is Limited Government Possible?," it is not proponents of anarcho-capitalism but rather those who advocate limited government who hold unrealistic views. Our author recognizes that "[t]here is a plethora of constitutional devices for 'rigging' rules and procedures in such a way as to clip the wings of the state" (p. 53). However, the real problem is not how to invent such devices but to find the conditions, if possible, that would be likely to be adopted and to stay intact long enough to do any good (ibid.). Jasay's economic reasoning here persuasively demonstrates why no such artificial restriction is likely to succeed, and why any government can be expected to have a tendency to grow (p. 57ff).

The other chapters of Part 1 are also interesting and insightful. "Frogs' Legs, Shared Ends, and the Rationality of Politics" (chap. 3) argues that politics generally cannot have rational grounds and cannot be rationally defended. This essay, however, seems more hastily written and more poorly organized than most others in the book. "The Twistable is Not Testable" (chap. 5), a review essay of Popper's *The Open Society and Its Enemies* (1962), shows Jasay at the height of his critical powers. In this piece, Jasay subjects Popper's own (socialistic) propositions "to the acid of the very method of which he is the champion" (p. 105), the test of falsifiability. Popper contended that "[g]enuine propositions are capable of being corroborated, and are criticized by a process of confrontation with the ascertainable facts of the case" (ibid.). However, Popper advocated both democracy and socialism; yet, as Jasay shows, this advocacy rests upon completely unfalsifiable building block descriptions, concepts, and judgments, such as "weak" and "strong." For example, these concepts are essential to the Popperian proposition that social institutions must be constructed to protect the "economically weak" from the "economically strong" (pp. 114–15). Thus, Jasay shows that Popper's socialism is indefensible by Popper's very own scientific standards.

In the course of this essay, Jasay also deflates the myth that Popper was a liberal (p. 114). Also of interest is Jasay's critical treatment of other prominent liberal economists and political theorists, notably James Buchanan, F.A. Hayek, and Robert Nozick. In "Hayek: Some Missing Pieces" (chap. 6), for example, Jasay argues that Hayek "has no complete theory of the social order to back up his liberal recommendations" (p. 120). In advocating that government should go beyond the maintenance of law and order to provide amorphous and endless "highly desirable" public goods, Hayek ends up supporting virtually unlimited government. Jasay will have none of this:

[2]Further, as Alfred G. Cuzán (1979, pp. 151–58) has insightfully pointed out, the existence of the state itself is evidence that anarchy is possible, for officials of the state "voluntarily" abide by certain hierarchies and rules, e.g., the American president is physically less powerful than his armies, yet they tend to obey him rather than *vice-versa*.

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> A theory of social order is incomplete if it makes no serious attempt at assessing the long-term forces that make the public sector grow or shrink. This can hardly be done without relying on a defensible theory of public goods. Hayek feels no necessity for one. Strangely, the question seems to have held no interest for him. (p. 125)

In other words, Hayek has not done his homework, and his half-baked political theory endangers the very freedom that he is viewed as upholding. (The critiques of Nozick and Buchanan are discussed below in Part 2.)

I have mentioned above that Jasay's work could be improved if it built more on and dealt more with contemporary Austrian theory, in particular Misesian economic theory as well as associated political theories, such as those of Rothbard. But this is unfair and somewhat ungrateful. We cannot rightfully criticize him for what he has not done, especially when what he has done is so significant. It might be better to say that, given his obvious acuity and talents, it seems a shame that he has not done so. One can only hope that we see more treatment and use of Austrian work in his further output.

For example, his discussions of the so-called public goods "dilemma" (pp. 20, 124) could have profited from the trenchant insights of Austrians Murray Rothbard (1962, p. 883; 1997a) and Hans-Hermann Hoppe (1993, chap. 1; 1998), among others. His discussion of why government will tend to grow (p. 57ff.) could also be usefully supplemented by recent Austrian politico-economic theory (Hoppe 1994a, pp. 319–51). Rothbard (relying on Schütz) criticized the empiricist assumption that only "verifiable" (or falsifiable) propositions are "scientific" and thus the existence of human action and even other human actors cannot be scientifically maintained, on the grounds that the principle of verifiability itself requires other human beings to exist to replicate experimental results (Rothbard 1997b, p. 33). This insight could have been used with profit in Jasay's Popper critique (chap. 5). Jasay's critiques of Nozick (pp. 170, 174, discussed below) and Hayek (chap. 6) could have also fit well with Austrian analysis.[3]

A more serious objection lies in Jasay's moral skepticism. His general skepticism serves him well as a critic, since it leads him invariably to put the burden of proof on those who advocate the state, and to find their proof wanting. However, his own skepticism goes too far and is itself unwarranted. It also undercuts his own positive theorizing, since even that, as tentative as it is, depends on some modicum of moral judgments or assumptions.

Jasay seems to believe that the only meaningful propositions are those that are subject to rational criticism, and that only falsifiable propositions that can be corroborated or not, fall into this category. One exception is that "value judgments" that are not merely *ad hoc*, i.e., that fit into some coherent hierarchy or system, can also be criticized if they are not internally consistent (p. 106). I may be too hasty here and may be unfairly attributing to him a kind of Popperian

[3]On Nozick, see Rothbard ([1982] 1998b); on the error in the Lockean proviso and Nozick's adoption thereof, see Hoppe (1993, p. 246); on Hayek, see Hoppe (1994b), and Walter Block (1996, pp. 327–50).

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scientism that he means to present and critique rather than adopt. However, over and over, Jasay denigrates the idea that ends or values can be rational. Thus, "[w]hat is ultimately unfalsifiable, immune to rational criticism and useless except as a piece of gratuitous self-expression, is the stand-alone, ad hoc value judgment" (p. 106; see also pp. 16–17, 36 n. 2, 66).

Here is where perhaps the greatest improvement could be made to Jasay's thought by careful consideration of important Austrian work. In particular, Hoppe's extension of praxeology into the field of ethics, the importance of which cannot be overstated, demonstrates that there is indeed an unchallengeable, rational basis for ethics (Hoppe 1989, chap. 7; 1993; Kinsella 1994; 1997; 1996; Rothbard [1982] 1998b; [1973] 1978; 1985). In fact, in his skepticism and his subsequently deficient political theorizing, Jasay has more in common with Mises than just economics. For Mises himself, as Rothbard (1997c, pp. 78–99) has pointed out, as an opponent of objective ethics, presented a weak, and, ultimately, unsuccessful, utilitarian defense of liberalism.

The most important and interesting essay of Part 2 is "Before Resorting to Politics" (chap. 8), which Jasay admits is "the book's most ambitious" (p. 6). In this chapter, he criticizes the consequentialism and other problems that, as he sees it, plague modern liberal theory. In its stead he "proposes three, admittedly sketchy, 'principles of politics,'" which are "entailed in the liberal ethic" and which must be incorporated into the foundations of any coherent liberal theory (p. 147).

As noted above, however, Jasay does not seem to believe that normative propositions can be justified, and he does not really try to do so. He just uses the occasional "should" and normative premise where it is unavoidable, and appears to simply presume that the reader shares these (uncontroversial) premises, perhaps counting on the reader's own goodwill or love of consistency. For example, he merely asserts that "[i]t is dubious in the extreme that a political authority is entitled to employ its power of coercion for imposing value choices on society . . . and on individual members" (p. 151). Yet the force of the normative concepts "dubious" and "entitled" here is diluted by the lack of even an attempt at justification.

Jasay's argument is thus a hypothetical one—and I am not sure if he would disagree, for I am not sure he thinks anything better is possible—for it relies for its persuasiveness on the listener already valuing (for some reason) the goals of justice, efficiency, and order. Nevertheless, because most of these principles are certainly sound and justifiable anyway (for example, using Rothbard's or Hoppe's ethical theory), and because Jasay's critical and analytical skills are so acute, much of interest emerges from this essay.

His three principles of politics are: (1) if in doubt, abstain from political action (pp. 147ff); (2) the feasible is presumed free (pp. 158ff); and (3) let exclusion stand (pp. 171ff). The justification of principle (1) begins with a vigorous critique of consequentialism. Jasay notes that most political action requires assessing the worth or value of various policies. Drawing on the idea that interpersonal utility and values are incommensurate, Jasay points out that we

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can rarely know if any proposed government measure is really "worth it" or not (pp. 149, 151). Thus, government action, which necessarily employs the power of coercion, should be avoided where possible; the burden of proof should be on those agitating for it. This entails a corollary principle, "that applying coercion is legitimate when it is positively invited by the prospective coercee" (p. 156).

Next, in principle (2), "the feasible is presumed free," Jasay asserts that "[t]he basic rule is that a person is presumed free to do what is feasible for him to do" (p. 160), as long as the proposed feasible action is not ruled out by his own obligations or the possibility of harm to others. We should live by right and not by permission, presumably in part because the former situation is more workable and efficient. If a feasible action is thus presumed free, then the actor need not prove that the action is permissible; rather, the burden is on him who challenges the permissibility of the action (ibid.). Otherwise, an actor might be unable to ever act since it would be essentially very difficult to prove a negative by showing that no one will be harmed.[4]

Incidentally, Jasay offers an interesting critique of Nozick's conception of rights here. By viewing rights as "permissions" to do something, rather than as claims for performance by another, Nozick perhaps unwittingly endorses a system in which action is not presumed free, as action is undertaken with "permission" by others, which presumably must first be granted (p. 170).

I found the justification of principle (3), "let exclusion stand," to be of most interest, especially the discussion of homesteading or appropriation of unowned goods. Jasay equates property with its owner's "excluding" others from using it, for example by fencing in immovable property (land) or finding or creating (and keeping) movable property (corporeal, tangible objects). Thus, the principle means "let ownership stand," i.e., that claims to ownership of property appropriated from the state of nature or acquired ultimately through a chain of title tracing back to such an appropriation should be respected.

The basic defense of the Lockean proposition that the first or original appropriator of property is entitled to appropriate it draws on his previous "feasible" principle (2) as well as his distinction between rights and liberties. Others have objected to the idea that one can appropriate unowned property on the grounds that such an action unilaterally (and thus unjustifiably) imposes on others moral duties to refrain from interfering.

> The basic defense, however, is quite general and straightforward. It is that if a prospective owner *can* in fact perform it, taking first possession of a thing is a feasible act of his that is

[4]Interestingly, Hoppe (1989, chap. 7; 1993, chaps. 8–11) has used similar reasoning in his argumentation ethics, based on the concept of action inherent in argumentation, to show that any arguer necessarily values action and its precondition, property rights. However, unlike Jasay, who seems unsure whether he is really justifying his principles or merely stating a nice, workable system that he, as a private citizen, happens to prefer, Hoppe employs this reasoning to derive an objective, rationalist justification for private property rights.

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> *admissible* if it is *not a tort* (in this case not trespass) and violates no right; but this is the case by definition, i.e., by the thing being identified as "unowned." (p. 173)

Thus, by treating individuals as being free to act unless it contravenes a right (claim) of another, there is simply no reason *not* to allow a person to appropriate unowned property. For who could object, if not another, prior owner? To be entitled to object is to be able to "exclude" the claimant, but the right to exclude is an incident of ownership, and the property is by presumption unowned. No one can validly object to my appropriating unowned property, then, because, assuming feasible actions are free, any objection itself must claim a right, and this itself raises a type of ownership claim.[5]

The beauty of this approach is that it avoids the troublesome "Lockean proviso," which allows homesteading of unowned goods only so long as "enough and as good is left to others" (p. 188, n. 15; see also 195). Nozick, on the other hand, allowed appropriation of an unowned object only if it did not worsen the situation of others. However, Jasay points out, in a world with finite resources, this condition would make it impossible for any unowned property to ever be used, since any appropriation causes a loss of opportunity for others to homestead the object and thereby worsens their situation. By contrast, Jasay's position "does not require that nobody loses as a result of first possession, as long as the losses were not vested interests" (p. 188, n. 15).

Jasay's application of his appropriation rule to two basic types of appropriation is also worth study. These two types are "finding and keeping" and "enclosure" (p. 174). The former appears to apply primarily to movable objects that may be found, taken, and hidden or used exclusively. Since the thing has no other owner, *prima facie* no one is entitled to object to the first possessor claiming ownership. Other grounds opposing this might be that the thing was found at least partly by luck, and was thus undeserved. But for this to be relevant, there would have to be a general rule requiring the lucky in life to compensate the unlucky. However, such a rule rests on an unsupportable assertion.

For immovable property (land), possession is taken by "enclosing" the land and incurring exclusion costs, e.g., erecting a fence. As in the case with movables, others' loss of the opportunity to appropriate the property does not give rise to a claim sufficient to oust the first possessor (if it did, it would be an ownership claim). However, for those who used to occasionally enjoy access to and use of the property, they do lose an actual benefit (pp. 176–77). Jasay admits that he cannot do full justice to this difficult issue, but offers a tentative solution. If some people previously used the property merely in passing, on an ad hoc basis, no right of theirs is violated by the homesteader enclosing it. However, if some identifiable, closed set of persons have used the property regularly enough to

[5]Similar reasoning is employed in my estoppel theory of rights to preclude someone from denying the rights that they necessarily presume exist in a certain context (punishment). This theory is related to and draws on Hoppe's argumentation ethics. See Kinsella (1997; 1996). Hoppe's insights into why the *first* appropriator has a better moral claim than latecomers is also of relevance here. See Hoppe (1989, pp. 141–44; 1993, pp. 191–93).

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establish a precedent on which they rely, compensation must be paid them by the new owner (p. 177). (It is unclear why this regular use and "precedent" does not itself establish an ownership claim on behalf of the prior users; but Jasay is here speaking of borderline cases.)

Other chapters in Part 2 argue that rational choices by individuals in the state of nature can be expected to lead to enforcement of property rights and contractual promises (chap. 9). This chapter also shows that James Buchanan's interpretation of Hobbes and history is incorrect, and that proper understanding of both supports the idea that markets can exist prior to and without states, contra Buchanan (p. 198). In the last chapter, "Liberties, Rights, and the Standing of Groups" (chap. 11), one has to agree with his conclusion that "group rights" are problematic, and the proper bearers of rights are individuals.

This is a thought-provoking book and I have only been able to touch upon some of the nuances and important insights it contains. Anthony de Jasay is a scholar and this work is an important contribution to economic and political literature; it should be read and studied by the serious student.

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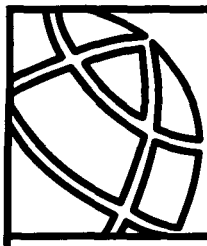

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